SHORE BANCSHARES INC
Form 10-Q
November 10, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2008

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

(410) 822-1400
Registrant’s Telephone Number, Including Area Code

N/A
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 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 x 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. (Check one):

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

(Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,404,684 shares of common stock outstanding as of October 31, 2008.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Cash and due from banks	$ **21,883**	$ 17,198
Interest bearing deposits with other banks	**513**	3,036
Federal funds sold	**15,416**	6,646
Investment securities:		
Available for sale, at fair value	**82,235**	97,137
Held-to-maturity, at amortized cost - fair value of $10,941 (2008) and $12,924 (2007)	**10,914**	12,896
Loans	**865,437**	776,350
Less: allowance for credit losses	**(8,618)**	(7,551)
Loans, net	**856,819**	768,799
Insurance premiums receivable	**1,164**	1,083
Premises and equipment, net	**14,097**	15,617
Accrued interest receivable	**5,023**	5,008
Investment in unconsolidated subsidiary	**-**	937
Goodwill	**15,954**	15,954
Other intangible assets, net	**6,050**	6,436
Deferred income taxes	**2,610**	1,847
Other real estate owned	**-**	176
Other assets	**4,348**	4,141
TOTAL ASSETS	$ **1,037,026**	$ 956,911
LIABILITIES		
Deposits:		
Noninterest bearing demand	$ **118,049**	$ 104,081
Interest bearing demand	**119,144**	115,623
Money market and savings	**182,397**	169,896
Certificates of deposit $100,000 or more	**197,590**	161,568
Other time	**222,037**	214,727
Total deposits	**839,217**	765,895
Accrued interest payable	**2,137**	2,793
Short-term borrowings	**53,078**	47,694
Long-term debt	**8,485**	12,485
Other liabilities	**8,708**	7,809
TOTAL LIABILITIES	**911,625**	836,676
STOCKHOLDERS' EQUITY		
Common stock, par value $.01; shares authorized - 35,000,000;	**84**	84

shares issued and outstanding - 8,404,609 (2008) and 8,380,530 (2007)				
Additional paid in capital		**29,744**		29,539
Retained earnings		**95,224**		90,365
Accumulated other comprehensive income		**349**		247
TOTAL STOCKHOLDERS' EQUITY		**125,401**		120,235
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$**	**1,037,026**	$	956,911

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	**2008**	2007
INTEREST INCOME				
Interest and fees on loans	**$ 14,179**	$ 14,732	**$ 42,700**	$ 42,566
Interest and dividends on investment securities:				
Taxable	**924**	1,325	**2,949**	3,900
Tax-exempt	**95**	128	**327**	387
Interest on federal funds sold	**79**	178	**284**	988
Interest on deposits with other banks	**21**	180	**88**	847
Total interest income	**15,298**	16,543	**46,348**	48,688
INTEREST EXPENSE				
Interest on deposits	**4,955**	5,493	**15,295**	16,263
Interest on short-term borrowings	**344**	279	**1,026**	838
Interest on long-term debt	**90**	308	**456**	977
Total interest expense	**5,389**	6,080	**16,777**	18,078
NET INTEREST INCOME	**9,909**	10,463	**29,571**	30,610
Provision for credit losses	**875**	604	**1,952**	1,259
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	**9,034**	9,859	**27,619**	29,351
NONINTEREST INCOME				
Service charges on deposit accounts	**923**	949	**2,711**	2,420
Other service charges and fees	**668**	501	**2,169**	1,489
Gain on sale of investment securities	-	**-**	-	1
Other than temporary impairment of securities	**(371)**	-	**(371)**	**-**
Insurance agency commissions	**2,845**	1,403	**9,595**	5,004
Gain (loss) on disposals of premises and equipment	**1,264**	(108)	**1,255**	(108)
Loss on sale of investment in unconsolidated subsidiary	**(337)**	**-**	**(337)**	**-**
Other noninterest income	**254**	310	**920**	1,158
Total noninterest income	**5,246**	3,055	**15,942**	9,964
NONINTEREST EXPENSE				
Salaries and wages	**4,662**	3,879	**13,837**	11,512
Employee benefits	**1,140**	944	**3,708**	2,959
Occupancy expense	**558**	460	**1,594**	1,444
Furniture and equipment expense	**310**	318	**894**	988
Data processing	**486**	454	**1,396**	1,353
Directors' fees	**131**	136	**426**	427
Amortization of other intangible assets	**128**	56	**386**	203
Agency commissions	**447**	-	**1,770**	**-**
Other noninterest expenses	**1,567**	1,352	**4,738**	4,351

Total noninterest expense		**9,429**		7,599		**28,749**		23,237
INCOME BEFORE INCOME TAXES		**4,851**		5,315		**14,812**		16,078
Income tax expense		**1,780**		1,964		**5,603**		5,968
NET INCOME	**$**	**3,071**	$	3,351	**$**	**9,209**	$	10,110
Basic earnings per common share	**$**	**0.37**	$	0.40	**$**	**1.10**	$	1.21
Diluted earnings per common share	**$**	**0.37**	$	0.40	**$**	**1.10**	$	1.20
Dividends paid per common share	**$**	**0.16**	$	0.16	**$**	**0.48**	$	0.48

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Nine Months Ended September 30, 2008 and 2007
(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2008	$ 84	$ 29,539	$ 90,365	$ 247	$ 120,235
Adjustment to initially apply EITF Issue 06-4	-	-	(318)	-	(318)
Comprehensive income:					
Net income	-	-	9,209	-	9,209
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	102	102
Total comprehensive income					9,311
Shares issued for employee stock-based awards	-	136	-	-	136
Stock-based compensation expense	-	69	-	-	69
Cash dividends paid ($0.48 per share)	-	-	(4,032)	-	(4,032)
Balances, September 30, 2008	**$ 84**	**$ 29,744**	**$ 95,224**	**$ 349**	**$ 125,401**
Balances, January 1, 2007	$ 84	$ 29,687	$ 82,279	$ (723)	$ 111,327
Comprehensive income:					
Net income	-	-	10,110	-	10,110
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	490	490
Total comprehensive income					10,600
Shares issued for employee stock-based awards	-	46	-	-	46
Stock-based compensation expense	-	51	-	-	51
Repurchase and retirement of 10,234 shares	-	(266)	-	-	(266)
Cash dividends paid ($0.48 per share)	-	-	(4,022)	-	(4,022)
Balances, September 30, 2007	$ 84	$ 29,518	$ 88,367	$ (233)	$ 117,736

See accompanying notes to Consolidated Financial Statements.

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

	For the Nine Months Ended September 30,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 9,209**	$ 10,110
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**1,330**	1,084
Stock-based compensation expense	**69**	51
Discount accretion on debt securities	**(164)**	(144)
Provision for credit losses	**1,952**	1,259
Gain on sale of securities	**-**	(1)
Other than temporary impairment of securities	**371**	-
(Gain) loss on disposals of premises and equipment	**(1,255)**	108
Loss on sale of investment in unconsolidated subsidiary	**337**	-
Loss (gain) on sale of other real estate owned	**50**	(13)
Net changes in:		
Insurance premiums receivable	**(81)**	324
Accrued interest receivable	**(15)**	(948)
Other assets	**(1,592)**	(766)
Accrued interest payable	**(656)**	(103)
Other liabilities	**579**	117
Net cash provided by operating activities	**10,134**	11,078
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of securities available for sale	**71,189**	65,646
Proceeds from sale of investment securities available for sale	**-**	500
Purchases of securities available for sale	**(56,416)**	(58,814)
Proceeds from maturities and principal payments of securities held to maturity	**2,991**	1,174
Purchases of securities held to maturity	**(1,012)**	(117)
Net increase in loans	**(90,109)**	(51,774)
Purchases of premises and equipment	**(292)**	(640)
Proceeds from sales of premises and equipment	**2,773**	-
Proceeds from sale of investment in unconsolidated subsidiary	**600**	-
Proceeds from sales of other real estate owned	**264**	364
Net cash used in investing activities	**(70,012)**	(43,661)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in demand, money market and savings deposits	**29,990**	(20,318)
Net increase in certificates of deposit	**43,332**	6,259
Net increase in short-term borrowings	**5,384**	10,864
Proceeds from issuance of long-term debt	**3,000**	-
Repayment of long-term debt	**(7,000)**	(9,000)
Proceeds from issuance of common stock	**136**	46
Stock repurchased and retired	-	(266)

Dividends paid		**(4,032)**		(4,022)
Net cash provided by (used in) financing activities		**70,810**		(16,437)
Net increase (decrease) in cash and cash equivalents		**10,932**		(49,020)
Cash and cash equivalents at beginning of period		**26,880**		79,673
Cash and cash equivalents at end of period	**$**	**37,812**	$	30,653
Supplemental cash flows information:				
Interest paid	**$**	**17,433**	$	18,181
Income taxes paid	**$**	**7,437**	$	6,474
Transfers from loans to other real estate owned	**$**	**138**	$	698

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2008 and 2007
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. (the "Company") and its subsidiaries 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 financial position at September 30, 2008, the results of operations for the three and nine months ended September 30, 2008 and 2007, changes in stockholders' equity for the nine months ended September 30, 2008 and 2007, and cash flows for the nine months ended September 30, 2008 and 2007, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2007 were derived from audited financial statements. The results of operations for the three and nine months ended September 30, 2008 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 Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Note 2 – Earnings Per Share

Basic earnings per share are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of outstanding stock options and awards. The following table provides information relating to the calculation of earnings per share:

(In thousands, except per share data)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	**2008**	2007
Net Income	**$ 3,071**	$ 3,351	**$ 9,209**	$ 10,110
Weighted Average Shares Outstanding – Basic	**8,388**	8,380	**8,382**	8,380
Dilutive effect of stock-based awards	**7**	12	**8**	14
Weighted Average Shares Outstanding – Diluted	**8,395**	8,392	**8,390**	8,394
Earnings per common share – Basic	**$ 0.37**	$ 0.40	**$ 1.10**	$ 1.21
Earnings per common share – Diluted	**$ 0.37**	$ 0.40	**$ 1.10**	$ 1.20

There were 3 thousand and 16 thousand antidilutive stock-based awards excluded from the earnings per share calculation for the three and nine months ended September 30, 2008, respectively. There were no antidilutive stock-based awards excluded from the earnings per share calculation for the three and nine months ended September 30, 2007.

Note 3 – Significant Accounting Policy

Under the provisions of Statements of Financial Accounting Standards (“SFAS”) Nos. 114 and 118, "Accounting by Creditors for Impairment of a Loan," 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 contracted terms. 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. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan’s principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Information with respect to impaired loans and the related valuation allowance is shown below:

(Dollars in thousands)	**September 30, 2008**	December 31, 2007	September 30, 2007
Impaired loans with a valuation allowance	**$ 2,290**	$ 3,413	$ 1,922
Impaired loans with no valuation allowance	**5,206**	127	1,784
Total impaired loans	**$ 7,496**	$ 3,540	$ 3,706
Allowance for credit losses applicable to impaired loans	**$ 318**	$ 819	$ 932
Allowance for credit losses applicable to other than impaired loans	**8,300**	6,732	6,289
Total allowance for credit losses	**$ 8,618**	$ 7,551	$ 7,221
Average recorded investment in impaired loans	**$ 4,817**	$ 3,958	$ 4,316

Gross interest income of $314 thousand for the first nine months of 2008, $404 thousand for fiscal year 2007 and $324 thousand for the first nine months of 2007 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was $193 thousand for the first nine months of 2008, $142 thousand for fiscal year 2007 and $133 thousand for the first nine months of 2007.

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 upon historical loss ratios and are included in the allowance for credit losses.

Note 4 – Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At September 30, 2008, total commitments to extend credit were approximately $221.0 million. The comparable amount was $246.3 million at December 31, 2007. Outstanding letters of credit were approximately $15.9 million at September 30, 2008 and $18.3 million at December 31, 2007.

Note 5 - Stock-Based Compensation

At September 30, 2008, the Company had two equity compensation plans: (i) the Shore Bancshares, Inc. Employee Stock Purchase Plan ("ESPP"); and (ii) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ("2006 Equity Plan"). In addition, at September 30, 2008, stock options remained outstanding under the Shore Bancshares, Inc. 1998 Stock Option Plan, which plan expired on March 3, 2008. The plans are described in detail in Note 13 to the audited financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Stock-based awards granted to date are generally time-based, vesting on each anniversary of the grant date over a three to five year period of time and, in the case of stock options, expiring 10 years from the grant date. ESPP awards allow employees to purchase shares of the Company's common stock at 85% of the fair market value on the date of grant. ESPP grants are 100% vested at date of grant and have a 27-month term.

During the three and nine months ended September 30, 2008, the Company recognized pre-tax stock-based compensation expense of $22 thousand and $69 thousand, respectively, compared to $22 thousand and $51 thousand, respectively, for the same periods last year. Stock-based compensation expense is recognized ratably over the requisite

service period for all awards and is based on the grant-date fair value. Unrecognized stock-based compensation expense related to nonvested share-based compensation arrangements was $323 thousand as of September 30, 2008. The weighted-average period over which this unrecognized expense was expected to be recognized was 3.8 years.

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. Stock-based compensation expense recognized in the consolidated statements of income for the nine months ended September 30, 2008 and 2007 reflected forfeitures as they occurred.

No options were granted during the first nine months of 2008 and 2007.

The following table summarizes stock option activity for the Company under all plans for the nine months ended September 30, 2008:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of year	33,797	$ 15.67	
Granted	-	-	
Exercised	(13,106)	15.42	
Expired/Cancelled	(2,066)	18.47	
Outstanding at end of period	18,625	15.54	$ 189,258
Exercisable at end of period	18,625	$ 15.54	$ 189,258

The following summarizes information about options outstanding at September 30, 2008:

		Options Outstanding and Exercisable	
Options Outstanding Exercise Price	Number	Number	Weighted Average Remaining Contract Life (in years)
$21.33	5,075	5,075	0.3
14.00	3,255	3,255	1.3
13.17	10,295	10,295	3.5
	18,625	18,625	

The total intrinsic value of stock options exercised during the nine months ended September 30, 2008 and 2007 was approximately $80 thousand and $30 thousand, respectively. Cash received upon exercise of options during the first nine months of 2008 and 2007 was approximately $136 thousand and $46 thousand, respectively.

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2008	3,845	$ 25.31
Granted	13,783	21.93
Vested	(769)	25.31
Cancelled	-	-
Nonvested at September 30, 2008	16,859	$ 22.55

Note 6 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 18-branch network. Community banking activities include small business services, retail brokerage, and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards,

accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

Selected financial information by line of business for the first nine months of 2008 and 2007 is included in the following table:

(Dollars in thousands)	Community banking	Insurance products and services	Parent Company	Total
2008				
Interest income	**$ 46,299**	**$ 49**	**$ -**	**$ 46,348**
Interest expense	**(16,676)**	**-**	**(101)**	**(16,777)**
Provision for credit losses	**(1,952)**	**-**	**-**	**(1,952)**
Noninterest income	**5,865**	**10,077**	**-**	**15,942**
Noninterest expense	**(15,486)**	**(9,128)**	**(4,135)**	**(28,749)**
Net intersegment income (expense)	**(3,577)**	**(312)**	**3,889**	**-**
Income before taxes	**14,473**	**686**	**(347)**	**14,812**
Income tax (expense) benefit	**(5,475)**	**(259)**	**131**	**(5,603)**
Net income	**$ 8,998**	**$ 427**	**$ (216)**	**$ 9,209**
Total assets	**$ 1,013,939**	**$ 20,332**	**$ 2,755**	**$ 1,037,026**
2007				
Interest income	$ 48,688	$ -	$ -	$ 48,688
Interest expense	(18,078)	-	-	(18,078)
Provision for credit losses	(1,259)	-	-	(1,259)
Noninterest income	4,914	5,050	-	9,964
Noninterest expense	(15,251)	(4,132)	(3,854)	(23,237)
Net intersegment income (expense)	(3,457)	(274)	3,731	-
Income before taxes	15,557	644	(123)	16,078
Income tax (expense) benefit	(5,792)	(255)	79	(5,968)
Net income	$ 9,765	$ 389	$ (44)	$ 10,110
Total assets	$ 927,468	$ 9,279	$ 3,130	$ 939,877

Note 7 – Fair Value Measurements

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 157, "*Fair Value Measurements*" which provides a framework for measuring and disclosing fair value under GAAP. SFAS 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans).

SFAS 157 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. SFAS 157 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 utilizes fair value measurements to record fair value adjustments to certain assets 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 loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under SFAS 157, the company groups assets and liabilities 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 the fair value. 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.

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Investment Securities Available for Sale
Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Loans
The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principle will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan." The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At September 30, 2008, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with SFAS 157, impaired loans that have an allowance established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis
The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis at September 30, 2008.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale	$ 82,235	-	$ 82,235	-

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis
The Company may be required from time to time to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. The table below presents the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis at September 30, 2008.

	Quoted Prices	Significant Other Observable Inputs	Significant Unobservable Inputs

(Dollars in thousands)	Fair Value	(Level 1)	(Level 2)	(Level 3)
Impaired loans	$ 7,178	-	-	$ 7,178

Impaired loans had a carrying amount of $7.5 million with a valuation allowance of $318 thousand at September 30, 2008.

Note 8 – Sale-leaseback

On April 17, 2008, the Company entered into a sale-leaseback agreement with Milford Plaza Enterprises, LLC ("Purchaser"). Under the agreement, the Company terminated its ground lease with the Purchaser and conveyed to the Purchaser title to the Company's improvements to the property, generally consisting of the Company's branch banking facility in Milford, Delaware. The Company received $1.3 million for this sale and an immaterial loss was recorded on the transaction. The Company has leased back the facility for an initial period of 12 years. Monthly rental expense under the agreement is approximately $11 thousand.

Note 9 – Other Than Temporary Impairment
The Company currently holds 10,000 shares of Federal Home Loan Mortgage Corporation (Freddie Mac) preferred stock. During the third quarter of 2008, Freddie Mac was placed in a government conservatorship which negatively impacted the market value of its stock. The Company determined that its investment in Freddie Mac sustained an other than temporary impairment and recorded a $371 thousand impairment loss in the third quarter of 2008.

Note 10 – New Accounting Pronouncements

Pronouncements adopted
SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88 106, and 132(R)." SFAS 158 requires an employer to recognize the overfunded or underfunded status of post-retirement defined benefit plans as an asset or a liability in its statement of financial position. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other post-retirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and the transition asset or obligation. The adoption of SFAS 158's requirement to recognize the funded status in the financial statements for fiscal years ending after December 15, 2006 did not have a significant impact on the Company's consolidated financial statements. SFAS 158's requirement to use the fiscal year-end date as the measurement date is effective for fiscal years ending after December 15, 2008, and did not have a significant impact on the Company's consolidated financial statements.

SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115." SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The Company adopted SFAS 159 on January 1, 2008 and has not elected the fair value option for any financial assets or liabilities at September 30, 2008.

The Emerging Issues Task Force ("EITF") of the FASB issued EITF Issue 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," which was effective January 1, 2008. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods as defined in SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity's obligation to the employee in this regard and thus the entity must record compensation cost and a related liability. Entities should recognize the effects of applying this Issue through either, (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods. This Issue is effective for fiscal years beginning after December 15, 2007. The effects of the guidance have been applied as a change in accounting principle through a cumulative-effect adjustment to retained earnings of $318,000.

EITF Issue 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." EITF 06-11 requires that tax benefits generated by dividends paid during the vesting period on certain equity-classified share-based compensation awards be classified as additional paid-in capital and included in a pool of excess tax benefits available to absorb tax deficiencies from share-based payment awards. EITF 06-11 is effective for years beginning after December 15, 2007. The adoption of EITF 06-11 did not have a significant impact on the Company's consolidated financial position or results of operations.

Pronouncements issued but not yet effective

SFAS No. 141R, "Business Combinations." SFAS 141R's objective is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after December 31, 2008. This statement will change the Company's accounting treatment for business combinations on a prospective basis.

SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements." SFAS 160's objective is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 shall be effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements.

SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133". SFAS 161 is intended to enhance the disclosures previously required for derivative instruments and hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", to include how and why an entity uses derivative instruments, how derivative instruments and related hedge items are accounted for and their impact on an entity's financial positions, results of operations and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.

SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States (the "GAAP hierarchy"). The FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and is issuing this Statement to achieve that result. This Statement is effective 60 days following the Security and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.* The Company does not expect the implementation of SFAS 162 to have a material impact on its consolidated financial statements.

SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts – an interpretation of FASB Statement No. 60." SFAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. The accounting and expanded disclosure requirements of SFAS 163 will improve the quality and comparability of financial information that will be provided to users of financial statements. This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years. This Statement also requires that disclosures about the risk-management activities of the insurance enterprise be effective for the first period (including interim periods) beginning after issuance of this Statement. The Company does not expect the implementation of SFAS 163 to have a material impact on its consolidated financial statements.

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 this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions ab our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates,

legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission entitled "Risk Factors" (see Item 1A of Part II of this report). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of Shore Bancshares, Inc. and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank"), The Centreville National Bank of Maryland located in Centreville, Maryland ("Centreville National Bank") and The Felton Bank, located in Felton, Delaware ("Felton Bank") (collectively, the "Banks"). The Banks operate 18 full service branches in Kent, Queen Anne's, Talbot, Caroline and Dorchester Counties in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the "Insurance Subsidiary") and the mortgage broker business through Wye Mortgage Group, LLC, all of which are wholly-owned subsidiaries of Shore Bancshares, Inc.

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

The Company maintains an Internet site at www.shbi.net 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 Securities and Exchange Commission.

Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability.

We believe that our most critical accounting policy relates to the allowance for credit losses. The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from management's estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the borrower's prospects of repayment, and in establishing allowance factors on the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management's continuing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio, and allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the

portfolio, and may result in additional provisions or charge-offs.

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. 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. When a loan is identified as impaired, a specific allowance is established based on our assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate and construction, residential real estate or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the formula or specific allowance.

RECENT GOVERNMENT ACTIONS

On October 14, 2008, the U.S. Department of the Treasury announced its capital purchase program designed to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Under this program, Treasury will purchase up to $250 billion of shares of senior preferred stock from qualifying U.S. financial institutions. The minimum and maximum subscription amounts available to a participating financial institution are 1% of its risk-weighted assets and the lesser of $25 billion or 3% of its risk-weighted assets, respectively.

On October 31, 2008, the Corporation's Board of Directors adopted resolutions authorizing the Corporation to apply for participation in the Capital Purchase Program. If the Corporation's application is approved and the Board determines to move forward, the Corporation would issue 25,000 shares of a new class of stock to be known as Fixed-Rate Cumulative Perpetual Preferred Stock, Series A (the "Preferred Stock"), and issue a warrant to purchase shares of common stock having a market value of $3.75 million. The Preferred Stock, which would qualify as Tier 1 regulatory capital, would be sold for an aggregate purchase price of $25.0 million, have a liquidation preference of $1,000 per share, pay cumulative quarterly dividends at a rate of 5% per year for the first five years and 9% per year thereafter, and be non-voting, other than class voting rights on certain matters that could adversely affect the shares. Until three years following the date of issuance, the Corporation would be able to redeem the Preferred Stock at par only using proceeds from a sale of Tier 1 qualifying perpetual preferred stock or common stock for cash which results in gross proceeds to the Corporation of not less than $6.25 million. After three years, the Corporation would be able to redeem the Preferred Stock at par, in whole or in part, at its discretion. Any redemption is subject to the consent of the Board of Governors of the Federal Reserve System. Also, until three years following the sale of the Preferred Stock, or such earlier time as the Preferred Stock has been redeemed or transferred by Treasury, the Corporation would not, without Treasury's consent, be permitted to increase the dividend per share on common stock or repurchase common stock.

The warrant would be immediately exercisable, with a 10-year term. The exercise price per share would be based upon the average of the closing prices of the Corporation's common stock during the 20-trading day period ending on the trading day prior to the issuance of the Preferred Stock. The exercise price and number of shares subject to the warrant would both be subject to anti-dilution adjustments. Treasury would agree not to exercise voting power with respect to any shares of common stock issued upon exercise of the warrant. If the Corporation were to receive aggregate gross cash proceeds of at least $25 million from one or more qualifying equity offerings of Tier 1-eligible perpetual preferred or common stock on or prior to December 31, 2009, then the number of shares of common stock underlying the warrant then held by Treasury would be reduced by one-half of the original number of shares, considering all adjustments, underlying the warrant.

The proceeds from the issuance would be allocated on a relative fair value basis between the Preferred Stock and the warrant. The Preferred Stock and the warrant would both be classified in stockholders' equity in our consolidated statement of condition. The issuance, including dividends, would likely result in a reduction of basic and diluted earnings per common share.

The Corporation would issue the Preferred Stock and the Warrant in a private placement exempt from the SEC's registration requirements, and would file a registration statement covering the resale of the Preferred Stock, the warrant and the shares of common stock underlying the warrant. Neither the Preferred Stock nor the warrant would be subject to any contractual restrictions on transfer, except that Treasury could only transfer or exercise an aggregate of one-half of the warrant shares prior to December 31, 2009, unless the Corporation were to receive gross proceeds from qualified equity offerings that are at least equal to the $25.0 million initially received from Treasury. During the period that Treasury holds any Preferred Stock, the warrant or any shares of our common stock issuable upon exercise of the warrant, we would be subject to certain restrictions on the compensation of our senior executive officers.

There can be no assurance that the Corporation's application will be accepted or that, even if it is, the Corporation will ultimately decide to participate in the Capital Purchase Program.

OVERVIEW

Net income for the third quarter of 2008 was $3.1 million, or diluted earnings per share of $0.37, compared to $3.4 million, or diluted earnings per share of $0.40, for the third quarter of 2007. For the second quarter of 2008, net income was $2.8 million or $0.33 per diluted share. Annualized return on average assets was 1.19% for the three months ended September 30, 2008, compared to 1.42% for the same period in 2007. Annualized return on average stockholders' equity was 9.81% for the third quarter of 2008, compared to 11.51% for the third quarter of 2007. For the second quarter of 2008, annualized return on average assets was 1.12% and return on average equity was 8.98%. Overall, third quarter 2008 results improved over second quarter 2008 results.

Net income for the first nine months of 2008 was $9.2 million, or diluted earnings per share of $1.10, compared to $10.1 million, or diluted earnings per share of $1.20, for the first nine months of 2007. Annualized return on average assets was 1.23% for the nine months ended September 30, 2008, compared to 1.43% for the same period in 2007. Annualized return on average stockholders' equity was 9.95% for the first nine months of 2008, compared to 11.76% for the first nine months of 2007.

RESULTS OF OPERATIONS

Net Interest Income
Net interest income for the three months ended September 30, 2008 was $9.9 million, a decrease of 5.3% when compared to the same period last year. Lower yields on earning assets were the primary reason for the decrease. The net interest margin was 4.10% for the third quarter of 2008, a decrease of 64 basis points when compared to the third quarter of 2007. The 225 basis-point reduction in interest rates by the Federal Reserve during the first nine months of 2008 had a significant impact on the overall yield on earning assets. Net interest income increased 2.9% from the second quarter of 2008 mainly due to higher loan volume. The net interest margin decreased just 7 basis points from 4.17% for the second quarter of 2008.

Interest income was $15.3 million for the third quarter of 2008, a decrease of 7.5% from the third quarter of 2007. Average earning assets increased 8.9% during the third quarter of 2008 when compared to the same period in 2007, while yields earned decreased 116 basis points to 6.30%. Average loans increased 15.7% while the yield earned on loans decreased 138 basis points. Loans comprised 87.9% and 82.7% of total average earning assets for the quarters ended September 30, 2008 and 2007, respectively. Interest income increased 1.1% when compared to the second quarter of 2008. Average earning assets increased 3.5% during the third quarter of 2008 when compared to the second quarter of 2008, while yields earned decreased 23 basis points.

Interest expense decreased 11.4% for the three months ended September 30, 2008 when compared to the same period last year. Average interest bearing liabilities increased 9.5%, while rates paid decreased 66 basis points to 2.75%. Average balances increased in all categories of interest bearing liabilities except for long-term debt. However, rates declined enough to reduce interest expense in all categories of interest bearing liabilities except for certificates of deposit $100,000 or more and short-term borrowings. The average balance of interest bearing deposits increased 8.6% for the quarter ended September 30, 2008 when compared to the same period in 2007. The overall rate paid for interest bearing deposits decreased 58 basis points to 2.74%. For the three months ended September 30, 2008, the average balance of certificates of deposits $100,000 or more increased 23.1% when compared to the same period last year, and the average rate paid for those certificates of deposit decreased 92 basis points to 3.95%. Interest expense decreased 1.9% when compared to the second quarter of 2008. Average interest bearing liabilities increased 3.2% during the quarter ended September 30, 2008 when compared to the second quarter of 2008, while rates paid decreased 17 basis points.

Net interest income for the nine months ended September 30, 2008 was $29.6 million, a decrease of 3.4% when compared to the same period last year. The decrease was primarily the result of lower yields on earning assets. The net interest margin was 4.22% for the first nine months of 2008, a decrease of 40 basis points when compared to the first nine months of 2007.

Interest income was $46.3 million for the first nine months of 2008, a decrease of 4.8% from the first nine months of 2007. Average earning assets increased 6.0% during the nine months ended September 30, 2008 when compared to the same period in 2007, while yields earned decreased 73 basis points to 6.59%. Average loans increased 15.1% during the first nine months of 2008, while the yield earned on loans decreased 100 basis points when compared to the same period of 2007. Loans comprised 87.2% and 80.4% of total average earning assets for the first nine months of 2008 and 2007, respectively.

Interest expense decreased 7.2% for the nine months ended September 30, 2008 when compared to the same period last year. Average interest bearing liabilities increased 6.3%, while rates paid decreased 43 basis points to 2.94%. Average balances increased in all categories of interest bearing liabilities except for long-term debt. However, rates declined enough to reduce interest expense in all categories of interest bearing liabilities except for certificates of deposit $100,000 or more and short-term borrowings. The average balance of interest bearing deposits increased 5.7% for the first nine months of 2008 when compared to the same period in 2007. The overall rate paid for interest bearing

deposits decreased 35 basis points to 2.92%. For the nine months ended September 30, 2008, the average balance of certificates of deposits $100,000 or more increased 17.6% when compared to the same period last year, and the average rate paid for those certificates of deposit decreased 60 basis points to 4.26%.

Analysis of Interest Rates and Interest Differentials

The following table presents 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, 2008 and 2007.

	For the Three Months Ended September 30, 2008			For the Three Months Ended September 30, 2007		
(Dollars in thousands)	**Average Balance**	**Income(1)/ Expense**	**Yield/ Rate**	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Investment securities						
Taxable	**$ 84,713**	**$ 924**	**4.34%**	$ 114,248	$ 1,325	4.64%
Tax-exempt	**10,320**	**145**	**5.63**	13,360	197	5.90
Loans (2), (3)	**854,371**	**14,225**	**6.62**	738,145	14,770	8.00
Federal funds sold	**17,921**	**79**	**1.74**	13,096	178	5.44
Interest bearing deposits	**4,218**	**21**	**2.01**	13,473	180	5.34
Total earning assets	**971,543**	**15,394**	**6.30%**	892,322	16,650	7.46%
Cash and due from banks	**14,306**			17,512		
Other assets	**50,358**			43,376		
Allowance for credit losses	**(8,468)**			(7,002)		
Total assets	**$ 1,027,739**			$ 946,208		
Interest bearing liabilities						
Demand deposits	**$ 112,000**	**97**	**0.34%**	$ 111,983	299	1.07%
Money market and savings deposits	**183,408**	**673**	**1.46**	177,077	811	1.83
Certificates of deposit $100,000 or more	**196,810**	**1,953**	**3.95**	159,917	1,945	4.87
Other time deposits	**226,110**	**2,232**	**3.93**	212,341	2,438	4.59
Interest bearing deposits	**718,328**	**4,955**	**2.74**	661,318	5,493	3.32
Short-term borrowings	**53,450**	**344**	**2.56**	28,884	279	3.86
Long-term debt	**8,485**	**90**	**4.21**	22,391	308	5.50
Total interest bearing liabilities	**780,263**	**5,389**	**2.75%**	712,593	6,080	3.41%
Noninterest bearing deposits	**111,915**			108,906		
Other liabilities	**10,978**			8,279		
Stockholders' equity	**124,583**			116,430		
Total liabilities and stockholders' equity	**$ 1,027,739**			$ 946,208		
Net interest spread		**$ 10,005**	**3.55%**		$ 10,570	4.05%
Net interest margin			**4.10%**			4.74%

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The following table presents 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, 2008 and 2007.

	For the Nine Months Ended September 30, 2008			For the Nine Months Ended September 30, 2007		
(Dollars in thousands)	**Average Balance**	**Income(1)/ Expense**	**Yield/ Rate**	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Investment securities						
Taxable	**$ 86,633**	**$ 2,949**	**4.55%**	$ 115,248	$ 3,900	4.51%
Tax-exempt	**11,395**	**502**	**5.89**	13,563	596	5.86
Loans (2), (3)	**824,775**	**42,829**	**6.94**	716,478	42,643	7.94
Federal funds sold	**17,893**	**284**	**2.12**	24,861	988	5.30
Interest bearing deposits	**4,746**	**88**	**2.49**	21,533	847	5.24
Total earning assets	**945,442**	**46,652**	**6.59%**	891,683	48,974	7.32%
Cash and due from banks	**14,408**			16,869		
Other assets	**50,690**			43,411		
Allowance for credit losses	**(8,097)**			(6,714)		
Total assets	**$ 1,002,443**			$ 945,249		
Interest bearing liabilities						
Demand deposits	**$ 112,309**	**363**	**0.43%**	$ 111,497	805	0.96%
Money market and savings deposits	**180,087**	**2,032**	**1.51**	178,459	2,386	1.78
Certificates of deposit $100,000 or more	**186,879**	**5,963**	**4.26**	158,889	5,794	4.86
Other time deposits	**221,564**	**6,937**	**4.18**	214,390	7,278	4.53
Interest bearing deposits	**700,839**	**15,295**	**2.92**	663,235	16,263	3.27
Short-term borrowings	**47,409**	**1,026**	**2.89**	28,841	838	3.88
Long-term debt	**12,821**	**456**	**4.75**	24,129	977	5.40
Total interest bearing liabilities	**761,069**	**16,777**	**2.94%**	716,205	18,078	3.37%
Noninterest bearing deposits	**106,328**			105,957		
Other liabilities	**11,419**			8,453		
Stockholders' equity	**123,627**			114,634		
Total liabilities and stockholders' equity	**$ 1,002,443**			$ 945,249		
Net interest spread		**$ 29,875**	**3.65%**		$ 30,896	3.95%
Net interest margin			**4.22%**			4.62%

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 35% exclusive of the alternative minimum tax rate and nondeductible interest expense.
(2) Average loan balances include nonaccrual loans.
(3) Interest income on loans includes amortized loan fees, net of costs, for each loan category and yield calculations are stated to include all.

Noninterest Income

Noninterest income for the third quarter of 2008 increased $2.2 million when compared to the third quarter of 2007. Service charges on deposit accounts decreased $26 thousand, other service charges and fees increased $167 thousand,

insurance agency commissions increased $1.4 million and other noninterest income decreased $56 thousand for the third quarter of 2008 when compared to the third quarter of 2007. The increase in insurance agency commissions was primarily the result of the acquisition of two insurance agencies during the fourth quarter of 2007. Included in total noninterest income was a $1.3 million gain on the sale of a bank branch to the State of Maryland as part of a road widening project. The branch remains open; however, the bank intends to move the branch to a new facility during 2009. The gain on the branch sale was partially offset by a $371 thousand other than temporary impairment of Freddie Mac Preferred Stock and a $337 thousand loss on the sale of the Company's investment in Delmarva Bank Data Processing Center, Inc., an unconsolidated subsidiary. Noninterest income increased $52 thousand from the second quarter of 2008 primarily due to the $1.3 million gain on the land and bank building sale reduced by the $708 thousand other than temporary impairment and loss. These increases were partially offset by a decrease in insurance agency commissions of $374 thousand.

Noninterest income for the first nine months of 2008 increased $6.0 million when compared to the first nine months of 2007. Service charges on deposit accounts increased $291 thousand, other service charges and fees increased $680 thousand, insurance agency commissions increased $4.6 million and other noninterest income decreased $238 thousand for the first nine months of 2008 when compared to the same period in 2007. The increase in other service charges and fees and insurance agency commissions was primarily the result of the acquisition of the two insurance agencies during the fourth quarter of 2007. Total noninterest income included the previously mentioned $1.3 million gain on the land and bank building sale and the $708 thousand other than temporary impairment and loss.

Noninterest Expense
Noninterest expense for the third quarter of 2008 increased $1.8 million when compared to the third quarter of 2007. The increase was primarily attributable to the operating expenses of the two insurance agencies acquired during the fourth quarter of 2007. Salaries and benefits increased $979 thousand, insurance agency commissions increased $447 thousand and other noninterest expenses increased $215 thousand for the third quarter of 2008 when compared to the third quarter of 2007. Noninterest expense decreased $300 thousand from the second quarter of 2008 primarily due to a decrease in agency commissions and other noninterest expenses.

Noninterest expense for the first nine months of 2008 increased $5.5 million when compared to the first nine months of 2007. The increase was primarily attributable to the operating expenses of the two insurance agencies acquired during the fourth quarter of 2007. Salaries and benefits increased $3.1 million, insurance agency commissions increased $1.8 million and other noninterest expenses increased $387 thousand for the first nine months of 2008 when compared to the same period last year.

Income Taxes
The effective tax rate was 36.7% for the three months ended September 30, 2008, compared to 37.0% for the same period last year. For the nine months ended September 30, 2008 and 2007, the effective tax rates were 37.8% and 37.1%, respectively. Management believes that currently there are no additional changes in tax laws or to our tax structure that are likely to have a material impact on our future effective tax rate.

ANALYSIS OF FINANCIAL CONDITION

Loans
Loans, net of unearned income, totaled $865.4 million at September 30, 2008, an increase of $89.1 million, or 11.5%, since December 31, 2007. Average loans, net of unearned income, were $854.4 million for the three months ended September 30, 2008, an increase of $116.2 million, or 15.7%, when compared to the same period last year. Average loans, net of unearned income, were $824.8 million for the nine months ended September 30, 2008, an increase of $108.3 million, or 15.1%, when compared to the same period in 2007.

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 debts. The allowance is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption “Critical Accounting Policies” for an overview of the underlying methodology management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three months ended September 30, 2008 and 2007 was $875 thousand and $604 thousand, respectively. The provision for credit losses for the second quarter of 2008 was $615 thousand. The increased provision for the third quarter of 2008 when compared to the third quarter of 2007 and the second quarter of 2008 reflected the continued growth in the loan portfolio, an increase in nonperforming assets and charge-offs, as well as current economic conditions. The provision for credit losses for the nine months ended September 30, 2008 and 2007 was $2.0 million and $1.3 million, respectively. Management believes that we continue to maintain strong underwriting guidelines and emphasize credit quality.

Our historical charge-off ratios remain lower than those of similarly sized institutions according to the most recent Bank Holding Company Performance Report prepared by the Federal Reserve Board. Net charge-offs were $539 thousand for the three months ended September 30, 2008, compared to $268 thousand for the same period last year and $259 thousand for the second quarter of 2008. The allowance for credit losses as a percentage of average loans was 1.01% for the third quarter of 2008, 0.98% for the third quarter of 2007 and 1.01% for the second quarter of 2008. Net charge-offs were $885 thousand for the first nine months of 2008, compared to $338 thousand for the same period in 2007. The allowance for credit losses as a percentage of average loans was 1.04% for the first nine months of 2008 and 1.01% for the same period last year. Nonperforming assets were $7.5 million at September 30, 2008, compared to $3.7 million at December 31, 2007. Loans past due 90 days and still accruing at September 30, 2008 decreased to $599 thousand from $1.6 million at December 31, 2007. Based on management’s quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision were adequate at September 30, 2008.

The following table presents a summary of the activity in the allowance for credit losses:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(Dollars in thousands)	**2008**	2007	**2008**	2007
Allowance balance - beginning of period	**$ 8,282**	$ 6,885	**$ 7,551**	$ 6,300
Charge-offs:				
Real estate	**(455)**	(40)	**(526)**	(40)
Consumer	**(63)**	(52)	**(198)**	(174)
Commercial and other	**(185)**	(206)	**(381)**	(241)
Totals	**(703)**	(298)	**(1,105)**	(455)
Recoveries:				
Real estate	**10**	-	**18**	-
Consumer	**34**	12	**75**	57
Commercial and other	**120**	18	**127**	60
Totals	**164**	30	**220**	117
Net charge-offs	**(539)**	(268)	**(885)**	(338)
Provision for credit losses	**875**	604	**1,952**	1,259
Allowance balance - end of period	**$ 8,618**	$ 7,221	**$ 8,618**	$ 7,221
Average loans outstanding during the period	**$ 854,371**	$ 738,145	**$ 824,775**	$ 716,478
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	**0.25%**	0.15%	**0.14%**	0.06%
Allowance for credit losses at period end as a percentage of average loans	**1.01%**	0.98%	**1.04%**	1.01%

Because most of our loans are secured by real estate, weaknesses in the local real estate market may have a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. Despite the weaknesses in the national economy and real estate market, management believes that the local economy and real estate market remain relatively stable.

We have a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, at September 30, 2008 were approximately $296.2 million, or 34.3% of total loans, compared to $249.5 million, or 32.1% of total loans at December 31, 2007. Construction and land development loans at September 30, 2008 were $174.9 million, or 20.2% of total loans, compared to $155.5 million, or 20.0% of total loans, at December 31, 2007. We do not engage in foreign or subprime lending activities.

Nonperforming Assets

The following table summarizes our nonperforming and past due assets:

(Dollars in thousands)	**September 30, 2008**	December 31, 2007
Nonperforming assets		
Nonaccrual loans	**$ 7,496**	$ 3,540
Other real estate owned	**-**	176
Total nonperforming assets	**7,496**	3,716
Loans 90 days past due and still accruing	**599**	1,606

Total nonperforming assets and past due loans	**$**	**8,095**	$	5,322

Investment Securities

Investment securities totaled $93.1 million at September 30, 2008, compared to $110.0 million at December 31, 2007. The decreased balance reflects the use of proceeds from maturing securities to fund loan growth. The average balance of investment securities was $95.0 million for the three months ended September 30, 2008, compared to $127.6 million for the same period in 2007. The tax equivalent yields on investment securities were 4.48% and 4.77% for the three months ended September 30, 2008 and 2007, respectively. The average balance of investment securities was $98.0 million for the nine months ended September 30, 2008, compared to $128.8 million for the same period in 2007. The tax equivalent yields on investment securities were 4.70% and 4.65% for the nine months ended September 30, 2008 and 2007, respectively.

Deposits
Total deposits at September 30, 2008 were $839.2 million, compared to $765.9 million at December 31, 2007. All categories of deposits grew from the comparable amounts at the end of 2007. The largest growth was in certificates of deposit of $100,000 or more which increased $36.0 million, or 22.3%, due primarily to increased deposits of a large municipal customer.

Short-Term Borrowings
Short-term borrowings at September 30, 2008 and December 31, 2007 were $53.1 million and $47.7 million, respectively. Short-term borrowings consisted of securities sold under agreements to repurchase, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank. Short-term advances are defined as those with original maturities of one year or less.

Long-Term Debt
At September 30, 2008 and December 31, 2007, the Company had the following long-term debt:

(Dollars in thousands)	**September 30, 2008**	December 31, 2007
Federal Home Loan Bank (FHLB) 5.69% Advance due June 2008	**$ -**	$ 7,000
FHLB 4.17% Advance due November 2009	**3,000**	3,000
FHLB 3.09% Advance due January 2010	**3,000**	-
Acquisition related debt, 4.08% interest, equal annual installments for five years	**2,485**	2,485
	$ 8,485	$ 12,485

Liquidity and Capital Resources
We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and Centreville National Bank are also members of the Federal Home Loan Bank of Atlanta and Felton Bank is a member of the Federal Home Loan Bank of Pittsburgh to which they have pledged collateral sufficient to permit additional borrowings of up to approximately $64.7 million in the aggregate at September 30, 2008. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was $125.4 million at September 30, 2008, an increase of 4.3% since December 31, 2007. Accumulated other comprehensive income, which consisted solely of net unrealized gains or losses on investment securities available for sale, increased $102 thousand since the end of 2007, resulting in accumulated other comprehensive income of $349 thousand at September 30, 2008.

Bank regulatory agencies have adopted various capital standards for financial institutions, including risk-based capital standards. The primary objectives of the risk-based capital framework are to provide a more consistent system for comparing capital positions of financial institutions and to take into account the different risks among financial institutions' assets and off-balance sheet items.

Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to average assets ratio (leverage ratio). In addition, regulatory agencies consider the published capital levels as minimum levels and may require a financial institution to maintain capital at higher levels. The Company's capital ratios continued to be well in excess of regulatory minimums.

A comparison of our capital ratios as of September 30, 2008 and December 31, 2007 to the minimum regulatory requirements is presented below:

	September 30, 2008	December 31, 2007	Minimum Regulatory Requirements
Tier 1 risk-based capital	**11.65%**	12.15%	4.00%
Total risk-based capital	**12.67%**	13.14%	8.00%
Leverage ratio	**10.25%**	10.50%	4.00%

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is to 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 Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007 under the caption “Market Risk Management”. 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, 2007.

Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 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 the Chief Executive Officer (“CEO”) and the Principal Accounting Officer (“PAO”), 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 as of September 30, 2008 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the third quarter of 2008, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1A. Risk Factors.

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2007. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed. The following discussion updates a risk factor that was contained in the Annual Report on Form 10-K to reflect recent changes in economic conditions.

A majority of our business is concentrated in Maryland and Delaware; a significant amount of our business is concentrated in real estate lending.

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, we make many real

estate secured loans, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. The national and local economies have weakened during the past two years in part due to the widely-reported problems in the sub-prime mortgage loan market. As a result, real estate values across the country, including in our market areas, have decreased and the general availability of credit, especially credit to be secured by real estate, has also decreased. These conditions have made it more difficult for real estate owners and owners of loans secured by real estate to sell their assets at the times and at the prices they desire. In addition, these conditions have increased the risk that the market values of the real estate securing our loans may deteriorate, which could cause us to lose money in the event a borrower fails to repay a loan and we are forced to foreclose on the property. There can be no guarantee as to when or whether economic conditions will improve.

Additionally, the Board of Governors of the Federal Reserve Board (the “FRB”) and the FDIC, along with the other federal banking regulators, issued final guidance on December 6, 2006 entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that institutions whose commercial real estate loans exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk and may be required to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. Based on our commercial real estate concentration as of September 30, 2008, we may be subject to further supervisory analysis during future examinations. We cannot guarantee that any risk management practices we implement will be effective to prevent losses relating to our commercial real estate portfolio. Management cannot predict the extent to which this guidance will impact our operations or capital requirements.

Other than as discussed above, management does not believe that any material changes in our risk factors have occurred since December 31, 2007.

Item 6. Exhibits.

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

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, 2008	By:	/s/ W. Moorhead Vermilye W. Moorhead Vermilye President/Chief Executive Officer
Date: November 6, 2008	By:	/s/ Susan E.Leaverton Susan E. Leaverton, CPA Treasurer/Principal Accounting Officer

EXHIBIT INDEX

Exhibit Number	Description
31.1	Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
31.2	Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
32.1	Certification of the CEO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
32.2	Certification of the PAO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).