

EAGLE BANCORP INC  
Form 10-K  
March 15, 2012

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

**FORM 10-K**

ý **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the fiscal year ended December 31, 2011**

o **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: 0-25923**

**Eagle Bancorp, Inc.**

(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**52-2061461**  
(I.R.S. Employer Identification Number)

**7815 Woodmont Avenue, Bethesda, Maryland**  
(Address of principal executive offices)

**20814**  
(Zip Code)

Registrant's telephone number, including area code: **(301) 986-1800**

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

<b>Title of class</b>	<b>Name of each exchange on which registered</b>
Common Stock, \$0.01 par value	The NASDAQ Capital Market

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Section 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes o No ý

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 ý No o

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Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

The aggregate market value of the outstanding Common Stock held by nonaffiliates as of June 30, 2011 was approximately \$219.4 million.

As of March 4, 2012, the number of outstanding shares of the Common Stock, \$0.01 par value, of Eagle Bancorp, Inc. was 20,212,835.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on May 17, 2012 are incorporated by reference in part III hereof.

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ANNUAL REPORT ON FORM 10-K**

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**PART I**

**ITEM 1. BUSINESS**

Eagle Bancorp, Inc. (the "Company") was incorporated under the laws of the State of Maryland on October 28, 1997, to serve as the bank holding company for EagleBank (the "Bank"). The Company was formed by a group of local businessmen and professionals with significant prior experience in community banking in the Company's market area, together with an experienced community bank senior management team. The Bank, a Maryland chartered commercial bank which is a member of the Federal Reserve System, is the Company's principal operating subsidiary. It commenced banking operations on July 20, 1998. As of December 31, 2011, the Bank operated fifteen offices: seven in Montgomery County, Maryland located in Rockville (3), Bethesda, Silver Spring, Potomac and Chevy Chase; five located in the District of Columbia; and three in Northern Virginia located in Tysons Corner, Ballston and Rosslyn. The Bank opened its sixteenth branch office in Reston, Virginia near Reston Town Center, in February 2012, and has announced an additional office projected to open in Merrifield, Virginia in the fall of 2012. The Bank seeks additional banking offices consistent with its strategic plan, although there can be no assurance that the Bank will establish any additional offices, or that any branch office will prove to be profitable.

Eagle Commercial Ventures, LLC ("ECV") a direct subsidiary, provides subordinated financing for the acquisition, development and construction of real estate projects. Bethesda Leasing, LLC, holds title to and operates real estate owned acquired through foreclosure. Eagle Insurance Services, LLC, provides commercial and retail insurance products through a referral arrangement with The Meltzer Group, a large well known insurance brokerage within the Company's market area.

The Bank operates as a community bank alternative to the super-regional financial institutions which dominate EagleBank's primary market area. The cornerstone of the Bank's philosophy is to provide superior, personalized service to its clients. The Bank focuses on relationship banking, providing each client with a number of services, familiarizing itself with, and addressing itself to, client needs in a proactive, personalized fashion. Management believes that the market segments which the Bank targets, small to medium-sized for profit and non-profit businesses and the consumer base of the Bank's market area, demand the convenience and personal service that a smaller, independent financial institution such as the Bank can offer. It is these themes of convenience and proactive personal service that form the basis for the Bank's business development strategies.

*Description of Services.* The Bank offers full commercial banking services to its business and professional clients as well as complete consumer banking services to individuals living and/or working in the service area. The Bank emphasizes providing commercial banking services to sole proprietorships, small and medium-sized businesses, partnerships, corporations, non-profit organizations and associations, and investors living and working in and near the Bank's primary service area. A full range of retail banking services are offered to accommodate the individual needs of both corporate customers as well as the community the Bank serves. The Bank also offers online banking and a remote deposit service which allows clients to facilitate and expedite deposit transactions through the use of electronic scanning devices.

The Bank has developed a loan portfolio consisting primarily of traditional business and real estate secured loans with a substantial portion having variable rates, and where the cash flow of the borrower/borrower's business is the principal source of debt service with a secondary emphasis on collateral. Real estate loans are made generally for commercial purposes and are structured using both variable and fixed rates and renegotiable rates which adjust in three to five years, with maturities of five to ten years. Consumer loans are comprised primarily of home equity lines of credit and structured with an interest only draw period followed either by a balloon maturity or a fully amortized repayment schedule. The Bank has developed significant expertise and commitment as a Small Business Administration ("SBA") lender.

All new business customers are screened to determine, in advance, their credit qualifications and history. This practice permits the Bank to respond quickly to credit requests as they arise.

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In general, the Bank offers the following credit services:

Commercial loans for business purposes including working capital, equipment purchases, real estate, lines of credit, and government contract financing. Asset based lending and accounts receivable financing are available on a selective basis.

Real estate loans, including construction loan financing, for business and investment purposes.

Business equipment financing.

Consumer home equity lines of credit and term loans.

Traditional general purpose consumer installment loans including automobile and personal loans. In addition, the Bank offers personal lines of credit.

Credit card services are offered through an outside vendor.

Residential mortgage loans.

The direct lending activities in which the Bank engages carry the risk that the borrowers will be unable to perform on their obligations. As such, interest rate policies of the Federal Reserve Board and general economic conditions, nationally and in the Bank's primary market area, have a significant impact on the Bank's and the Company's results of operations. To the extent that economic conditions deteriorate, business and individual borrowers may be less able to meet their obligations to the Bank in full, in a timely manner, resulting in decreased earnings or losses to the Bank. To the extent the Bank makes fixed rate loans, general increases in interest rates will tend to reduce the Bank's spread as the interest rates the Bank must pay for deposits may increase while interest income may be unchanged. Economic conditions may also adversely affect the value of property pledged as security for loans.

The Bank's goal is to mitigate risks in the event of unforeseen threats to the loan portfolio as a result of economic downturn or other negative influences. Plans for mitigating inherent risks in managing loan assets include; carefully enforcing loan policies and procedures, evaluating each borrower's business plan during the underwriting process and throughout the loan term, identifying and monitoring primary and alternative sources for loan repayment, and obtaining collateral to mitigate economic loss in the event of liquidation. Specific loan reserves are established based upon credit and/or collateral risks on an individual loan basis. A risk rating system is employed to proactively estimate loss exposure and provide a measuring system for setting general and specific reserve allocations.

Under certain circumstances, the Bank attempts to further mitigate commercial term loan losses by using loan guarantee programs offered by the SBA. The Bank has been approved for the SBA's Preferred Lender Program ("PLP"). SBA loans made using PLP by the Bank are not subject to SBA pre-approval.

Refer to Critical Accounting Policies at page 35; and Allowance for Credit Losses at page 53 for further discussion of credit risk management policies and practices.

The composition of the Bank's loan portfolio is heavily weighted toward commercial real estate, both owner occupied and investment real estate. At December 31, 2011, commercial real estate, and real estate construction combined represented approximately 70% of the loan portfolio. Owner occupied commercial real estate and owner occupied commercial real estate construction represent 13.5% of the loan portfolio. When owner occupied commercial real estate is excluded, the percentage of total loans decreases to 56.5%. These loans are underwritten to mitigate lending risks typical of this type of loan such as declines in real estate values, changes in borrower cash flow and general economic conditions. The Bank typically requires a maximum loan to value of 80% or less and minimum cash flow debt service coverage of 1.15 to 1.0. Personal guarantees are generally required, but may be limited. In making real estate commercial mortgage loans, the Bank generally requires that interest rates adjust not less frequently than five years.



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The Bank is also an active traditional commercial lender providing loans for a variety of purposes, including cash flow, equipment and account receivable financing. This loan category represents approximately 23% of the loan portfolio at December 31, 2011 and is generally variable or adjustable rate. Commercial loans meet reasonable underwriting standards, including appropriate collateral, and cash flow necessary to support debt service. Personal guarantees are generally required, but may be limited. SBA loans represent 2% of the commercial loan category of loans. In originating SBA loans, the Company assumes the risk of non-payment on the uninsured portion of the credit. The Company generally sells the insured portion of the loan generating noninterest income from the gains on sale, as well as servicing income on the portion participated. SBA loans are subject to the same cash flow analyses as other commercial loans. SBA loans are subject to a maximum loan size established by the SBA.

Approximately 5% of the loan portfolio at December 31, 2011 consists of home equity loans and lines of credit and other consumer loans. These credits, while making up a smaller portion of the loan portfolio, demand the same emphasis on underwriting and credit evaluation as other types of loans advanced by the Bank.

The remaining 2% of the loan portfolio consists of residential home mortgage loans. These credits represent first liens on residential property loans originated by the Bank. While the Bank's business practices are to originate and sell (servicing released) loans made by its Residential Lending division, certain loan terms do not fit well the requirements of third party investors and are instead maintained in the Bank's portfolio. These type loans exhibit minimal credit risk.

At January 31, 2012, the Bank had a legal lending limit of \$42.2 million. Due to legal lending limitations, the Bank occasionally participates portions of credits to other area banks. The Bank has also participated loans to the Company until such time as the Bank could accommodate the participation within its legal limit or the loan could be participated to another lender. No loan participations to the Company are outstanding at December 31, 2011. The ability of the Company to assist the Bank with these credits has expanded the flexibility and service the Bank can offer its customers

From time to time the Company may make loans for its own portfolio or through its higher risk loan affiliate, ECV, which under its operating agreement conducts lending only to real estate projects, as to which the Company's directors or lending officers have significant expertise. Such loans may have higher risk characteristics than loans made by the Bank, such as lower priority interests and/or higher loan to value ratios. The Company seeks an overall financial return on these transactions commensurate with the risks and structure of each individual loan. Certain transactions bear current interest at a rate with a significant premium to normal market rates. Other loan transactions carry a standard rate of current interest, but also earn additional interest based on a fixed rate or a percentage of the profits of the underlying project. Refer to the discussion under "Management's Discussion and Analysis Noninterest Income" at page 45 and "Loan Portfolio" at page 50, for further information on the Company's and ECV's higher risk lending activities. At December 31, 2011, ECV had three outstanding loan transactions totaling \$2.3 million.

The risk of nonpayment (or deferred payment) of loans is inherent in commercial banking. The Bank's marketing focus on small to medium-sized businesses may result in the assumption by the Bank of certain lending risks that are different from those attendant to loans to larger companies. The management and director committees of the Bank carefully evaluate all loan applications and attempt to minimize credit risk exposure by use of extensive loan application data, due diligence, and approval and monitoring procedures; however, there can be no assurance that such procedures can significantly reduce such lending risks.

The Bank originates residential mortgage loans primarily as a correspondent lender. With only rare exceptions, the loans are registered with one of the designated investors at the time of application with intentions of immediate sale to that investor on a servicing released basis. This activity is managed by utilizing the available pricing, programs and lock periods which produce market gains on the sale of the

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loan. Activity in the residential mortgage loan market is highly sensitive to changes in interest rates and product availability. While the Bank does have delegated underwriting authority from most of its investors, it also employs the services of the investor to underwrite the loans. Because the loans are originated with investor guidelines, designated automated underwriting and product specific requirements as part of the loan application, the loans sold have a limited recourse provision. Most contracts with investors contain recourse periods. In general, the Company may be required to repurchase a previously sold mortgage loan or indemnify the investor if there is non-compliance with defined loan origination or documentation standards, including fraud, negligence or material misstatement in the loan documents. In addition, the Company may have an obligation to repurchase a loan if the mortgagor has defaulted early in the loan term. The potential default repurchase period is up to approximately twelve months after sale of the loan to the investor. Mortgages subject to recourse are collateralized by single-family residential properties, have loan-to-value ratios of 80% or less, or have private mortgage insurance. In certain instances, the Bank may provide equity loans (second position financing) in combination with residential first mortgage lending for purchase money and refinancing purposes. The Bank also brokers loan transactions with two investors, where the Bank refers, but does not underwrite and does not close the loan transaction. In this situation the Bank has no recourse liability for the loan.

The general terms and underwriting standards for each type of commercial real estate and construction loan are incorporated into the Bank's lending policies. These policies are analyzed periodically by management, and the policies are reviewed and approved by the Board on an annual basis. The Bank's loan policies and practices described in this report are subject to periodic change, and each guideline or standard is subject to waiver or exception in the case of any particular loan, by the appropriate officer or committee, in accordance with the Bank's loan policies. Policy standards are often stated in mandatory terms, such as "shall" or "must", but these provisions are subject to exceptions. Policy requires that loan value not exceed a percentage of "market value" or "fair value" based upon appraisals or evaluations obtained in the ordinary course of the Bank's underwriting practices.

Loans are secured primarily by duly recorded first deeds of trust. In some cases, the Bank may accept a recorded second trust position. In general, borrowers will have a proven ability to build, lease, manage and/or sell a commercial or residential project and demonstrate satisfactory financial condition. Additionally, an equity contribution toward the project is required.

Construction loans require that the financial condition and experience of the general contractor and major subcontractors be satisfactory to the Bank. Guaranteed, fixed price construction contracts are required whenever appropriate, along with payment and performance bonds or completion bonds for larger scale projects.

Loans intended for residential land acquisition, lot development and construction are made on the premise that the land: 1) is or will be developed for building sites for residential structures; and 2) will ultimately be utilized for construction or improvement of residential zoned real properties, including the creation of housing. Residential development and construction loans will finance projects such as single family subdivisions, planned unit developments, townhouses, and condominiums. Residential land acquisition, development and construction loans generally are underwritten with a maximum term of 36 months, including extensions approved at origination.

Commercial land acquisition and construction loans are secured by real property where loan funds will be used to acquire land and to construct or improve appropriately zoned real property for the creation of income producing or owner user commercial properties. Borrowers are required to contribute equity into each project at levels determined by the appropriate Loan Committee. Commercial land acquisition and construction loans generally are underwritten with a maximum term of 24 months.

Loan-to-value ("LTV") ratios, with few exceptions, are maintained consistent with or below supervisory guidelines.

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All construction draw requests must be presented in writing on American Institute of Architects documents and certified by the contractor, the borrower and the borrower's architect. Each draw request shall also include the borrower's soft cost breakdown certified by the borrower or its Chief Financial Officer. Prior to an advance, the Bank or its contractor inspects the project to determine that the work has been completed, to justify the draw requisition.

Commercial permanent loans are secured by improved real property which is generating income in the normal course of operation. Debt service coverage, assuming stabilized occupancy, must be satisfactory to support a permanent loan. The debt service coverage ratio is ordinarily at least 1.15 to 1. As part of the underwriting process, debt service coverage ratios are stress tested assuming a 200 basis point increase in interest rates from their current levels.

Commercial permanent loans generally subject to re-pricing after 5 years and are underwritten with a term not greater than 10 years or the remaining useful life of the property, whichever is lower. The preferred term is between 5 to 7 years, with amortization to a maximum of 25 years.

Personal guarantees are generally received from the principals, and only in instances where the loan-to-value is sufficiently low and the debt service is sufficiently high is consideration given to either limiting or not requiring personal recourse.

Updated appraisals for real estate secured loans are obtained as necessary and appropriate to borrower financial condition, project status, loan terms, and market conditions.

The Company's loan portfolio includes loans made for real estate Acquisition, Development and Construction ("ADC") purposes, including both investment and owner occupied projects. ADC loans amounted to \$429.7 million at December 31, 2011. The ADC loans containing loan funded interest reserves represent approximately 39% of the outstanding ADC loan portfolio at December 31, 2011. The decision to establish a loan-funded interest reserve is made upon origination of the ADC loan and is based upon a number of factors considered during underwriting of the credit including: (i) the feasibility of the project; (ii) the experience of the sponsor; (iii) the creditworthiness of the borrower and guarantors; (iv) borrower equity contribution; and (v) the level of collateral protection. When appropriate, an interest reserve provides an effective means of addressing the cash flow characteristics of a properly underwritten ADC loan. The Company does not significantly utilize interest reserves in other loan products. The Company recognizes that one of the risks inherent in the use of interest reserves is the potential masking of underlying problems with the project and/or the borrower's ability to repay the loan. In order to mitigate this inherent risk, the Company employs a series of reporting and monitoring mechanisms on all ADC loans, whether or not an interest reserve is provided, including: (i) construction and development timelines which are monitored on an ongoing basis which track the progress of a given project to the timeline projected at origination; (ii) a construction loan administration department independent of the lending function; (iii) third party independent construction loan inspection reports; (iv) monthly interest reserve monitoring reports detailing the balance of the interest reserves approved at origination and the days of interest carry represented by the reserve balances as compared to the then current anticipated time to completion and/or sale of speculative projects; and (v) quarterly commercial real estate construction meetings among senior Company management which includes monitoring of current and projected real estate market conditions. If a project has not performed as expected, it is not the customary practice of the Company to increase loan funded interest reserves.

Despite the softening economy and real estate markets in general, to date, the Company has not experienced any significant issues with increased vacancy rates or lower rents for income producing properties financed. However, the construction loan portfolio has felt to some extent the impacts of a softer market and slower absorption, although the Washington, D.C. metropolitan area real estate market has been very strong, as compared to other markets in the U.S. Some general slowness in turn of projects has impacted the liquidity of borrowers and guarantors. As a result the Company has maintained higher allocation factors (established in 2008) for the ALLL for the real estate loan portfolio. This increase has

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had an impact on the provision expense which results in marginal decrease in net income. Management carefully reviews the Bank's portfolio and general economic and market conditions on a regular basis and will continue to adjust both the specific and environmental reserve factors as necessary.

Deposit services include business and personal checking accounts, NOW accounts, tiered savings and money market account and time deposits with varying maturity structures and customer options. A complete individual retirement account program is available. In cooperation with Goldman Sachs Asset Management, the bank offers a Goldman Sachs Investment Sweep Account, a check writing cash management account that sweeps funds to one of several off-balance sheet investment accounts managed by Goldman Sachs. The bank also participates in the Promontory Financial Group's Insure Cash Sweep program.

The bank offers a full range of on-line banking services for both personal and business accounts. Other services include cash management services, business sweep accounts, lock box, and account reconciliation services, merchant card services, safety deposit boxes and Automated Clearing House origination. After-hours depositories and ATM service are also available.

The Bank and Company maintain portfolios of short term investments and investment securities consisting primarily of U.S. Government Agency bonds and government sponsored enterprise mortgage backed securities, and municipal bonds. The Company also owns equity investments related to membership in the Federal Reserve System and the Federal Home Loan Bank ("FHLB"). The Company's securities portfolio also consists of equity investments in the form of common stocks. The Company holds limited equity investments in local banking companies. These portfolios provide the following objectives: liquidity management, additional income to the Company and Bank in the form of interest and gain on sale opportunities, collateral to facilitate borrowing arrangements and assistance with meeting interest rate risk management objectives.

The Company and Bank have formalized an asset and liability management process and have a standing Asset Liability Committee ("ALCO") consisting both of outside and inside directors. The ALCO operates under established policies and practices, which are updated and re-approved annually. A typical Committee meeting includes discussion of current economic conditions and strategies, including interest rate trends and volumes positions, the current balance sheet and earnings position, cash flow estimates, liquidity positions and funding alternatives as necessary, interest rate risk position (quarterly), capital position, review of the investment portfolio of the Bank and the Company, and the approval of investment transactions. The current Investment Policy limits the Bank to investments of high quality, U.S. Treasury securities, U.S. Government agency securities and high grade municipal securities. High risk investments, derivatives and non traditional investments are prohibited, although the Bank does have investments in structured notes, which are permitted under the investment policy and which are performing well. Investment maturities are generally limited to ten to fifteen years, except as specifically approved by the ALCO, and mortgage backed pass through securities with average lives generally not to exceed eight years.

The Bank's customer base has benefited from the extensive business and personal contacts of its Directors and Executive Officers. To introduce new customers to the Bank, enhanced reliance is expected on proactively designed officer calling programs, active participation in business organizations, newly created advisory board structures and enhanced referral programs.

The Company provides access to its SEC filings through its web site at [www.eaglebankcorp.com](http://www.eaglebankcorp.com) by linking to the SEC's web site. After accessing the web site, the filings are available upon selecting "Investor Relations SEC Filings." Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed with or furnished to the SEC.

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**MARKET AREA AND COMPETITION**

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The Bank's main office and the headquarters of the Company and the Bank are located at 7815 Woodmont Avenue, Bethesda, Maryland 20814. The Bank has six additional Maryland offices, located at 110 North Washington Street, Rockville; 8665 Georgia Avenue, Silver Spring; 130 Rollins Avenue, Rockville; 9600 Blackwell Road, Rockville; 15 Wisconsin Circle, Chevy Chase; and 12505 Park Potomac Avenue, Potomac. There are five offices in Washington, D.C., located at 2001 K Street, NW; 1044 Wisconsin Ave, NW; 1228 Connecticut Ave, NW, 1425 K Street, NW; and 700 7<sup>th</sup> Street, NW. The Bank has three offices in Virginia, located at 8601 Westwood Center Drive, Vienna; 4420 N. Fairfax Drive, Arlington; and 1919 North Lynn St, Arlington. The Bank opened its sixteenth branch office in Reston, Virginia at 12011 Sunset Hills Road near Reston Town Center, in February 2012, and has announced an additional office projected to open in Merrifield, Virginia in the fall of 2012.

The primary service area of the Bank is the Washington, D.C. metropolitan area. With a population of approximately 6,200,000 (January, 2009), the region is the 5<sup>th</sup> largest market in the U.S. Total employment in the region is approximately 2,300,000. The region has the highest total of job creation of any market in the country with reported new job creation of more than 285,000 jobs since 2000. The Washington, D.C. metropolitan area contains a substantial federal workforce, as well as supporting a variety of support industries such as attorneys, lobbyists, government contractors, real estate developers and investors, non-profit organizations, tourism and consultants. The Gross Regional Product for 2010 was reported at \$436 billion. Of this about \$79 billion or 18% is spending by the federal government for procurement as of fiscal year 2010. The economic engine is well balanced with 37% contributed by local businesses. The regional economy is further supplied by national and international businesses at 16%. The region also has a very active non-profit sector including trade associations, colleges and universities and major hospitals.

Montgomery County, Maryland with a total population of approximately 972,000 (2010) and occupying an area of about 500 square miles is located roughly 30 miles southwest of Baltimore and is a diverse and healthy segment of Maryland's economy. Montgomery County is a thriving business center and is Maryland's most populous jurisdiction. Population growth in the county is expected to grow 3.8% between 2010 and 2015. While the State of Maryland boasts a demographic profile superior to the U.S. economy at large, the economy in and around Montgomery County is among the very best in Maryland. According to data from the Maryland National Capital Parks and Planning Commission, the number of jobs in the County has been relatively stable in the recent past with the public sector contributing about 19% of the employment. This is due to federal as well as state and local government employment. The unemployment rate in Montgomery County is among the lowest in the state at 4.8% (December 2011), and has declined as compared to December 2010 (5.1%). A very educated population has contributed to favorable median household income of \$93,373 (July 2010) with the number of households in excess of 353,100. According to the 2010 census update, approximately 57% of the County's residents (between 2006 and 2010) hold college or advanced degrees with 89% of households having computers, placing the population of Montgomery County among the most educated levels in the nation. The area boasts a diverse business climate of 33,000 businesses with 510,000 jobs in addition to a strong federal government presence. Major areas of employment include a substantial technology sector, biotechnology, software development, a housing construction and renovation sector, and a legal, financial services and professional services sector. Major private employers include Adventist Healthcare, Lockheed Martin, Giant Food, and Marriott International. The county is also an incubator for firms engaged in bio-technology and the area has traditionally attracted significant amounts of venture capital. Transportation congestion remains the biggest threat to future economic development and the quality of life in the area.

Montgomery County is home to many major federal and private sector research and development and regulatory agencies, including the National Institute of Standards and Technology, the National Institutes of Health, National Oceanic and Atmospheric Administration, Naval Research and Development Center, Naval Surface Warfare Center, Nuclear Regulatory Commission, the Food and Drug Administration and the Walter Reed National Military Medical Center in Bethesda.

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Washington, D.C. in addition to being the seat of the Federal government is a vibrant city with a well educated, diverse population. According to survey estimates from the U.S. Census, the 2010 population of the District of Columbia is approximately 601,700, up from about 572,000 in 2000. Median household income, at \$58,526 (between 2006 - 2010), is above the national median level of \$51,914. The growth of residents in the city is due partially to improvements in the city's services and also to the many housing options available, ranging from grand old apartment buildings to Federal era town homes to the most modern condominiums. As of 2010, the housing market has grown to over 296,000 units. During 2010, the absorption of condominium units in the District has continued at a satisfactory pace. The inventory of new condominium units dropped from a peak of over 5,100 units at the end of 2006 to 700 units at year end 2010. While the Federal government and its employees are a major factor in the economy, over 100 million square feet of commercial office space support a dynamic business community of more than 20,000 companies. These include law and accounting firms, trade and professional associations, information technology companies, international financial institutions, health and education organizations and research and management companies. The vacancy rate for office space in the city fell from a peak of 11.8% in mid-2010 to 10.6% at the end of 2011. This was the second lowest vacancy rate in rankings of the largest downtown markets. Employment in the city was approximately 711,300 as of June 2011 up from 693,000 as of 2010. Statistics indicate that the District of Columbia lost 600 jobs, net, in 2009, particularly in the construction and retail industries. However, it also gained jobs in the professional sectors. In 2010 the city gained approximately 10,500 jobs, mostly in white collar positions. Unemployment has remained stable with the rate for December 2011 at 10.1%, level with December 2010 also at 10.1%. The disparity between the high level of unemployment among District residents and the strong employment trends reflects the high level of jobs held by residents of the surrounding suburban jurisdictions. The District has a well educated and highly paid work force. Over 51% of the jobs in the city are in managerial or professional positions. The Federal Government provides approximately 30% of the employment and professional service firms provide an additional 21%. Other large employers include the many local universities and hospitals. Another significant factor in the economy is the leisure and hospitality industry.

Fairfax County, Virginia is a large, affluent jurisdiction with a population of approximately 1,081,700 as of 2010. This county of about 395 square miles is located west of Washington, D.C. Fairfax County is one of the leading technology centers in the United States. Six Fortune 500 companies are headquartered in the county and 26 of the largest 100 technology federal contractors in the Washington metropolitan area are located in Fairfax. The county has over 113 million square feet of office space and is one of the largest suburban office markets in the United States. The midyear 2011 office vacancy rate was 12.8%, below the national average of 17.4% as measured in early 2011. It is a thriving residential as well as business center with 381,700 households which are expected to grow at about 1% per annum over the next 5 to 10 years. The county is among the most affluent in the country with average household income of \$105,416 per annum between 2006 and 2010. Total employment was over 573,000 as of 2009. The county did experience loss of jobs during 2009, although job growth of 9,500 positions was reported for 2010. Major companies headquartered in the county, which are also major employers, include Capital One Financial, CSC, Gannett, General Dynamics, Hilton Hotels, SAIC and Sallie Mae. The county is also home to several federal agencies including the CIA, Fort Belvoir and a major facility of the Smithsonian Institution.

The most recent addition to the Company's footprint, Arlington County, Virginia has a population of over 207,600 as of 2010. The county is made up of 26 square miles and is situated just west of Washington, D.C., directly across the Potomac River. There are approximately 91,890 households with a median household income of \$57,724 on average between 2006 and 2010. There were over 168,900 employees as of June 2011 working predominantly in the public sector. Significant private sector employers include Deloitte, Lockheed Martin Corporation, Virginia Hospital Center and Marriott International, Inc. Unemployment was 3.6% as of December 2011 compared to 3.7% in the prior year. These numbers compare favorably to the region, the rest of Virginia and the country. Arlington County has approximately 36.3 million square feet of office space with a vacancy rate of approximately 10.1% as of the fourth quarter

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2011. The population is highly educated with over 70% of residents over 25 years of age holding at least a bachelor's degree as of 2010.

Deregulation of financial institutions and holding company acquisitions of banks across state lines has resulted in widespread, fundamental changes in the financial services industry. This transformation, although occurring nationwide, is particularly intense in the greater Washington, D.C. metropolitan area because of the changes in the area's economic base in recent years and changing state laws authorizing interstate mergers and acquisitions of banks, and the interstate establishment or acquisition of branches.

Throughout the Washington, D.C. metropolitan area, competition is keen from large banking institutions headquartered outside of Maryland. In addition, the Bank competes with other community banks, savings and loan associations, credit unions, mortgage companies, finance companies and others providing financial services. Among the advantages that many of these large institutions have over the Bank are their abilities to finance extensive advertising campaigns, maintain extensive branch networks and technology investments, and to directly offer certain services, such as international banking and trust services, which are not offered directly by the Bank. Further, the greater capitalization of the larger institutions allows for substantially higher lending limits than the Bank. Certain of these competitors have other advantages, such as tax exemption in the case of credit unions, and lesser regulation in the case of mortgage companies and finance companies, although this regulatory oversight is undergoing dramatic change. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted in July 2010, regulation of all financial firms has been heightened. Under current law, unlimited interstate *de novo* branching is available to all state and federally chartered banks. As a result, institutions which previously were ineligible to establish *de novo* branches in the Company's market area may elect to do so.

**EMPLOYEES**

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At December 31, 2011 the Bank employed 338 persons on a full time basis, nine of whom are executive officers of the Bank, which compares to 292 employees at December 31, 2010. None of the Bank's employees are represented by any collective bargaining group, and the Bank believes that its employee relations are good. The Bank provides a benefit program which includes health and dental insurance, a 401(k) plan, life and long term disability insurance. Additionally, the Company maintains a stock-based compensation plan for employees of the Bank who meet certain eligibility requirements.

**REGULATION**

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*The Company.* The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, (the "Act") and is subject to supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). As a bank holding company, the Company is required to file with the Federal Reserve Board an annual report and such other additional information as the Federal Reserve Board may require pursuant to the Act. The Federal Reserve Board may also make examinations of the Company and each of its subsidiaries.

The Act requires approval of the Federal Reserve Board for, among other things, the acquisition by a proposed bank holding company of control of more than five percent (5%) of the voting shares, or substantially all the assets, of any bank or the merger or consolidation by a bank holding company with another bank holding company. The Act also generally permits the acquisition by a bank holding company of control or substantially all the assets of any bank located in a state other than the home state of the bank holding company, except where the bank has not been in existence for the minimum period of time required by state law; but if the bank is at least 5 years old, the Federal Reserve Board may approve the acquisition.

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With certain limited exceptions, a bank holding company is prohibited from acquiring control of any voting shares of any company which is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or furnishing services to or performing service for its authorized subsidiaries. A bank holding company may, however, engage in or acquire an interest in, a company that engages in activities which the Federal Reserve Board has determined by order or regulation to be so closely related to banking or managing or controlling banks as to be properly incident thereto. In making such a determination, the Federal Reserve Board is required to consider whether the performance of such activities can reasonably be expected to produce benefits to the public, such as convenience, increased competition or gains in efficiency, which outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The Federal Reserve Board is also empowered to differentiate between activities commenced *de novo* and activities commenced by the acquisition, in whole or in part, of a going concern. Some of the activities that the Federal Reserve Board has determined by regulation to be closely related to banking include making or servicing loans, performing certain data processing services, acting as a fiduciary or investment or financial advisor, and making investments in corporations or projects designed primarily to promote community welfare.

Subsidiary banks of a bank holding company are subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or any of its subsidiaries, or investments in the stock or other securities thereof, and on the taking of such stock or securities as collateral for loans to any borrower. Further, a holding company and any subsidiary bank are prohibited from engaging in certain tie-in arrangements in connection with the extension of credit. A subsidiary bank may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer obtain or provide some additional credit, property or services from or to such bank other than a loan, discount, deposit or trust service; (ii) the customer obtain or provide some additional credit, property or service from or to the Company or any other subsidiary of the Company; or (iii) the customer not obtain some other credit, property or service from competitors, except for reasonable requirements to assure the soundness of credit extended.

Effective on March 11, 2000, the Gramm Leach-Bliley Act of 1999 (the "GLB Act") allows a bank holding company or other company to certify status as a financial holding company, which allows such company to engage in activities that are financial in nature, that are incidental to such activities, or are complementary to such activities. The GLB Act enumerates certain activities that are deemed financial in nature, such as underwriting insurance or acting as an insurance principal, agent or broker, underwriting, dealing in or making markets in securities, and engaging in merchant banking under certain restrictions. It also authorizes the Federal Reserve Board to determine by regulation what other activities are financial in nature, or incidental or complementary thereto. The GLB Act allows a wider array of companies to own banks, which could result in companies with resources substantially in excess of the Company's entering into competition with the Company and the Bank.

The Dodd-Frank Act contains various provisions designed to enhance the regulation of depository institutions and prevent the recurrence of a financial crisis such as occurred in 2008-2009. Also included is the creation of a new federal agency to administer and enforce consumer and fair lending laws, a function that is now performed by the depository institution regulators. The full impact of the Dodd-Frank Act on the Company's business and operations will not be known for years until regulations implementing the statute are written and adopted. The Dodd-Frank Act may have a material impact on the Company's operations, particularly through increased compliance costs resulting from possible future consumer and fair lending regulations.

*The Bank.* The Bank, as a Maryland chartered commercial bank which is a member of the Federal Reserve System (a "state member bank") and whose accounts are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation (the "FDIC") up to the maximum legal limits of the FDIC, is subject to regulation, supervision and regular examination by the Maryland Department of Financial

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Institutions and the Federal Reserve Board. The regulations of these various agencies govern most aspects of the Bank's business, including required reserves against deposits, loans, investments, mergers and acquisitions, borrowing, dividends and location and number of branch offices.

The laws and regulations governing the Bank generally have been promulgated to protect depositors and the deposit insurance funds, and not for the purpose of protecting shareholders.

Competition among commercial banks, savings and loan associations, and credit unions has increased following enactment of legislation which greatly expanded the ability of banks and bank holding companies to engage in interstate banking or acquisition activities. As a result of federal and state legislation, banks in the Washington, D.C./Maryland/Virginia area can, subject to limited restrictions, acquire or merge with a bank in another of the jurisdictions, and can branch *de novo* in any of the jurisdictions.

Banking is a business which depends on interest rate differentials. In general, the differences between the interest paid by a bank on its deposits and its other borrowings and the interest received by a bank on loans extended to its customers and securities held in its investment portfolio constitute the major portion of the bank's earnings. Thus, the earnings and growth of the Bank will be subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve Board, which regulates the supply of money through various means including open market dealings in United States government securities. The nature and timing of changes in such policies and their impact on the Bank cannot be predicted.

*Branching and Interstate Banking.* The federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether such transaction is prohibited by the law of any state, unless the home state of one of the banks has opted out of the interstate bank merger provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Riegle-Neal Act") by adopting a law after the date of enactment of the Riegle-Neal Act and prior to June 1, 1997 which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate acquisitions of branches are permitted only if the law of the state in which the branch is located permits such acquisitions. Such interstate bank mergers and branch acquisitions are also subject to the nationwide and statewide insured deposit concentration limitations described in the Riegle-Neal Act. The District of Columbia, Maryland and Virginia have each enacted laws which permit interstate acquisitions of banks and bank branches. The Dodd-Frank Act authorizes national and state banks to establish *de novo* branches in other states to the same extent as a bank chartered by that state would be permitted to branch. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Although the District of Columbia, Maryland and Virginia had all enacted laws which permitted banks in these jurisdictions to branch freely, the branching provisions of the Dodd-Frank Act could result in banks from a wider variety of states establishing *de novo* branches in the Bank's market area.

The GLB Act made substantial changes in the historic restrictions on non-bank activities of bank holding companies, and allows affiliations between types of companies that were previously prohibited. The GLB Act also allows banks to engage in a wider array of non banking activities through "financial subsidiaries."

*USA Patriot Act.* Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, commonly referred to as the "USA Patriot Act" or the "Patriot Act," financial institutions are subject to prohibitions against specified financial transactions and account relationships, as well as enhanced due diligence standards intended to detect, and prevent, the use of the United States financial system for money laundering and terrorist financing activities. The Patriot Act requires financial institutions, including banks, to establish anti-money laundering programs, including employee training and independent audit requirements, meet minimum standards specified by the act, follow minimum standards for customer identification and maintenance of customer identification records, and regularly compare customer lists against lists of suspected terrorists, terrorist organizations and money

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launderers. The costs or other effects of the compliance burdens imposed by the Patriot Act or future anti-terrorist, homeland security or anti-money laundering legislation or regulation cannot be predicted with certainty.

*Capital Adequacy Guidelines.* The Federal Reserve Board and the FDIC have adopted risk based capital adequacy guidelines pursuant to which they assess the adequacy of capital in examining and supervising banks and bank holding companies and in analyzing bank regulatory applications. Risk-based capital requirements determine the adequacy of capital based on the risk inherent in various classes of assets and off-balance sheet items. Under the Dodd-Frank Act, the Federal Reserve Board is required to apply consolidated capital requirements to depository institution holding companies that are no less stringent than those currently applied to depository institutions. The Dodd-Frank Act additionally requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

State member banks are expected to meet a minimum ratio of total qualifying capital (the sum of core capital (Tier 1) and supplementary capital (Tier 2) to risk weighted assets of 8%. At least half of this amount (4%) should be in the form of core capital.

Tier 1 Capital generally consists of the sum of common shareholders' equity and perpetual preferred stock (subject in the case of the latter to limitations on the kind and amount of such stock which may be included as Tier 1 Capital), less goodwill, without adjustment for changes in the market value of securities classified as "available-for-sale," together with a limited amount of other qualifying interests, including trust preferred securities. The cumulative perpetual stock issued to the United States Department of the Treasury (the "Treasury") pursuant to the Trouble Assets Relief Program Capital Purchase Program (the "Capital Purchase Program") is eligible for treatment as Tier 1 capital without limitation. Tier 2 Capital consists of the following: hybrid capital instruments; perpetual preferred stock which is not otherwise eligible to be included as Tier 1 Capital; term subordinated debt and intermediate-term preferred stock; and, subject to limitations, general allowances for loan losses and excess restricted core capital elements. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no risk-based capital) for assets such as cash, to 100% for the bulk of assets which are typically held by a bank holding company, including certain multi-family residential and commercial real estate loans, commercial business loans and consumer loans. Residential first mortgage loans on one to four family residential real estate and certain seasoned multi-family residential real estate loans, which are not 90 days or more past due or nonperforming and which have been made in accordance with prudent underwriting standards are assigned a 50% level in the risk-weighting system, as are certain privately-issued mortgage-backed securities representing indirect ownership of such loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics. Under guidance adopted by the federal banking regulators, banks which have concentrations in construction, land development or commercial real estate loans (other than loans for majority owner occupied properties) would be expected to maintain higher levels of risk management and, potentially, higher levels of capital.

In addition to the risk-based capital requirements, the Federal Reserve Board has established a minimum 3.0% Leverage Capital Ratio (Tier 1 Capital to total adjusted assets) requirement for the most highly-rated banks, with an additional cushion of at least 100 to 200 basis points for all other banks, which effectively increases the minimum Leverage Capital Ratio for such other banks to 4.0% 5.0% or more. The highest-rated banks are those that are not anticipating or experiencing significant growth and have well diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, those which are considered a strong banking organization. A bank having less than the minimum Leverage Capital Ratio requirement shall, within 60 days of the date as of which it fails to comply with such requirement, submit a reasonable plan describing the means and timing by which the bank shall achieve its minimum Leverage Capital Ratio requirement. A bank which fails to file such plan is deemed to be operating in an unsafe and unsound manner, and could subject the bank to a

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cease-and-desist order. Any insured depository institution with a Leverage Capital Ratio that is less than 2.0% is deemed to be operating in an unsafe or unsound condition pursuant to Section 8(a) of the Federal Deposit Insurance Act (the "FDIA") and is subject to potential termination of deposit insurance. However, such an institution will not be subject to an enforcement proceeding solely on account of its capital ratios, if it has entered into and is in compliance with a written agreement to increase its Leverage Capital Ratio and to take such other action as may be necessary for the institution to be operated in a safe and sound manner. The capital regulations also provide, among other things, for the issuance of a capital directive, which is a final order issued to a bank that fails to maintain minimum capital or to restore its capital to the minimum capital requirement within a specified time period. Such directive is enforceable in the same manner as a final cease-and-desist order.

*Proposed Changes in Capital Requirements.* In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation ("Basel III"). Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain more capital, with a greater emphasis on common equity. Implementation is presently scheduled to be phased in between 2013 and 2019, although it is possible that implementation may be delayed as a result of multiple factors including the current condition of the banking industry within the U.S. and abroad.

The Basel III final capital framework, among other things, (i) introduces as a new capital measure "Common Equity Tier 1" ("CET1"), (ii) specifies that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expands the scope of the adjustments as compared to existing regulations.

When fully phased in, Basel III requires banks to maintain (i) as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a "capital conservation buffer" of 2.5%; (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer; (iii) a minimum ratio of Total (Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0% plus the capital conservation buffer and (iv) as a newly adopted international standard, a minimum leverage ratio of 3%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter).

Basel III also provides for a "countercyclical capital buffer," generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk that would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) may face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

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The U.S. banking agencies have indicated that they expect to propose regulations implementing Basel III, with final adoption of implementing regulations in mid-2012. Notwithstanding its release of the Basel III framework as a final framework, the Basel Committee is considering further amendments to Basel III. In addition to Basel III, Dodd-Frank requires or permits the Federal banking agencies to adopt regulations affecting banking institutions' capital requirements in a number of respects, including potentially more stringent capital requirements for systemically important financial institutions. Accordingly, the regulations ultimately applicable to us may be substantially different from the Basel III final framework as published in December 2010. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact our net income and return on equity.

*Prompt Corrective Action.* Under Section 38 of the FDIA, each federal banking agency is required to implement a system of prompt corrective action for institutions which it regulates. The federal banking agencies have promulgated substantially similar regulations to implement the system of prompt corrective action established by Section 38 of the FDIA. Under the regulations, a bank shall be deemed to be: (i) "well capitalized" if it has a Total Risk Based Capital Ratio of 10.0% or more, a Tier 1 Risk Based Capital Ratio of 6.0% or more, a Leverage Capital Ratio of 5.0% or more and is not subject to any written capital order or directive; (ii) "adequately capitalized" if it has a Total Risk Based Capital Ratio of 8.0% or more, a Tier 1 Risk Based Capital Ratio of 4.0% or more and a Tier 1 Leverage Capital Ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of "well capitalized;" (iii) "undercapitalized" if it has a Total Risk Based Capital Ratio that is less than 8.0%, a Tier 1 Risk based Capital Ratio that is less than 4.0% or a Leverage Capital Ratio that is less than 4.0% (3.0% under certain circumstances); (iv) "significantly undercapitalized" if it has a Total Risk Based Capital Ratio that is less than 6.0%, a Tier 1 Risk Based Capital Ratio that is less than 3.0% or a Leverage Capital Ratio that is less than 3.0%; and (v) "critically undercapitalized" if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

An institution generally must file a written capital restoration plan which meets specified requirements with an appropriate federal banking agency within 45 days of the date the institution receives notice or is deemed to have notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. A federal banking agency must provide the institution with written notice of approval or disapproval within 60 days after receiving a capital restoration plan, subject to extensions by the applicable agency.

An institution which is required to submit a capital restoration plan must concurrently submit a performance guaranty by each company that controls the institution. Such guaranty shall be limited to the lesser of (i) an amount equal to 5.0% of the institution's total assets at the time the institution was notified or deemed to have notice that it was undercapitalized or (ii) the amount necessary at such time to restore the relevant capital measures of the institution to the levels required for the institution to be classified as adequately capitalized. Such a guaranty shall expire after the federal banking agency notifies the institution that it has remained adequately capitalized for each of four consecutive calendar quarters. An institution which fails to submit a written capital restoration plan within the requisite period, including any required performance guaranty, or fails in any material respect to implement a capital restoration plan, shall be subject to the restrictions in Section 38 of the FDIA which are applicable to significantly undercapitalized institutions.

A "critically undercapitalized institution" is to be placed in conservatorship or receivership within 90 days unless the FDIC formally determines that forbearance from such action would better protect the deposit insurance fund. Unless the FDIC or other appropriate federal banking regulatory agency makes specific further findings and certifies that the institution is viable and is not expected to fail, an institution that remains critically undercapitalized on average during the fourth calendar quarter after the date it becomes critically undercapitalized must be placed in receivership. The general rule is that the FDIC will be appointed as receiver within 90 days after a bank becomes critically undercapitalized unless extremely good cause is shown and an extension is agreed to by the federal regulators. In general, good cause is

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defined as capital which has been raised and is imminently available for infusion into the Bank except for certain technical requirements which may delay the infusion for a period of time beyond the 90 day time period.

Immediately upon becoming undercapitalized, an institution shall become subject to the provisions of Section 38 of the FDIA, which (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution's assets; and (v) require prior approval of certain expansion proposals. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the deposit insurance fund, subject in certain cases to specified procedures. These discretionary supervisory actions include: requiring the institution to raise additional capital; restricting transactions with affiliates; requiring divestiture of the institution or the sale of the institution to a willing purchaser; and any other supervisory action that the agency deems appropriate. These and additional mandatory and permissive supervisory actions may be taken with respect to significantly undercapitalized and critically undercapitalized institutions.

Additionally, under Section 11(c)(5) of the FDIA, a conservator or receiver may be appointed for an institution where: (i) an institution's obligations exceed its assets; (ii) there is substantial dissipation of the institution's assets or earnings as a result of any violation of law or any unsafe or unsound practice; (iii) the institution is in an unsafe or unsound condition; (iv) there is a willful violation of a cease-and-desist order; (v) the institution is unable to pay its obligations in the ordinary course of business; (vi) losses or threatened losses deplete all or substantially all of an institution's capital, and there is no reasonable prospect of becoming "adequately capitalized" without assistance; (vii) there is any violation of law or unsafe or unsound practice or condition that is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the institution's condition, or otherwise seriously prejudice the interests of depositors or the insurance fund; (viii) an institution ceases to be insured; (ix) the institution is undercapitalized and has no reasonable prospect that it will become adequately capitalized, fails to become adequately capitalized when required to do so, or fails to submit or materially implement a capital restoration plan; or (x) the institution is critically undercapitalized or otherwise has substantially insufficient capital.

*Regulatory Enforcement Authority.* Federal banking law grants substantial enforcement powers to federal banking regulators. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities.

As a result of the volatility and instability in the financial system during 2008 and 2009, the Congress, the bank regulatory authorities and other government agencies have called for or proposed additional regulation and restrictions on the activities, practices and operations of banks and their holding companies. While many of these proposals relate to institutions that have accepted investments from, or sold troubled assets to, the Department of the Treasury or other government agencies, or otherwise participate in government programs intended to promote financial stabilization, the Congress and the federal banking agencies have broad authority to require all banks and holding companies to adhere to more rigorous or costly operating procedures, corporate governance procedures, or to engage in activities or practices which they would not otherwise elect. Any such requirement could adversely affect the Company's business and results of operations.

*FDIC Insurance Premiums.* The FDIC maintains a risk-based assessment system for determining deposit insurance premiums. Four risk categories (I-IV), each subject to different premium rates, are

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established, based upon an institution's status as well capitalized, adequately capitalized or undercapitalized, and the institution's supervisory rating. The levels of rates are subject to periodic adjustment by the FDIC. Depository institutions will also pay premiums for the increased coverage provided by the FDIC.

Dodd-Frank permanently increased the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. Dodd-Frank also broadened the base for FDIC insurance assessments. Assessments are now based on a financial institution's average consolidated total assets less tangible equity capital. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Dodd-Frank eliminated the statutory prohibition against the payment of interest on business checking accounts, effective in July 2011.

There are three adjustments that can be made to an institution's initial base assessment rate: (1) a potential decrease for long-term unsecured debt, including senior and subordinated debt and, for small institutions, a portion of Tier 1 capital; (2) a potential increase for secured liabilities above a threshold amount; and (3) for non-Risk Category I institutions, a potential increase for brokered deposits above a threshold amount. The current schedule for base assessment rates and potential adjustment is set forth in the following table.

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV	Large and Highly Complex Institutions
Initial Base Assessment Rate	5 to 9	14	23	35	5 to 35
Unsecured Debt Adjustment (added)	(4.5) to 0	(5) to 0	(5) to 0	(5) to 0	(5) to 0
Brokered Deposit Adjustment (added)	N/A	0 to 10	0 to 10	0 to 10	0 to 10
Total Base Assessment Rate	2.5 to 9	9 to 24	18 to 33	30 to 45	2.5 to 45

Additionally, the FDIC may impose special assessments from time to time.

*Consumer Financial Protection Bureau.* The Dodd-Frank Act creates a new, independent federal agency called the Consumer Financial Protection Bureau ("CFPB") which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions such as the Company will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense.

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**ITEM 1A. RISK FACTORS**

*An investment in our common stock involves a high degree of risk. Before making an investment decision, you should carefully read and consider the risk factors described below as well as the other information included in this report and other documents we file with the SEC, as the same may be updated from time to time. Any of these risks, if they actually occur, could materially adversely affect our business, financial condition, and results of operations. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect us. In any such case, you could lose all or a portion of your original investment.*

**The price of our common stock may fluctuate significantly, which may make it difficult for investors to resell shares of common stock at time or prices they find attractive.**

Our stock price may fluctuate significantly as a result of a variety of factors, many of which are beyond our control. These factors include, in addition to those described above:

Actual or anticipated quarterly fluctuations in our operating results and financial condition;

Changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to us or other financial institutions;

Speculation in the press or investment community generally or relating to our reputation or the financial services industry;

Strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;

Fluctuations in the stock price and operating results of our competitors;

Future sales of our equity or equity-related securities;

Proposed or adopted regulatory changes or developments;

Anticipated or pending investigations, proceedings, or litigation that involve or affect us;

Domestic and international economic factors unrelated to our performance; and

General market conditions and, in particular, developments related to market conditions for the financial services industry.

In addition, in recent years, the stock market in general has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market price of securities issued by many companies, including for reasons unrelated to their operating performance. These broad market fluctuations may adversely affect our stock price, notwithstanding our operating results. We expect that the market price of our common stock will continue to fluctuate and there can be no assurances about the levels of the market prices for our common stock.

**Trading in the common stock has been relatively light. As a result, shareholders may not be able to quickly and easily sell their common stock, particularly in large quantities.**

Although our common stock is listed for trading on The NASDAQ Capital Market and a number of brokers offer to make a market in the common stock on a regular basis, trading volume to date has been limited, averaging approximately 49,113 shares per day during 2011, and there can be no assurance that a continuously active and liquid market for the common stock can be maintained. As a result, shareholders may

find it difficult to sell a significant number of shares at the prevailing market price.

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**Our ability to pay dividends on the common stock, or repurchase shares of common stock may be limited.**

Under the terms of the our Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") issued under the Small Business Lending Fund Program (the "SBLF"), our ability to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of common stock is subject to restrictions. No repurchases of common stock may be effected, and no dividends may be declared or paid on the common stock during the current quarter and for the next three quarters following the failure to declare and pay dividends on the Series B Preferred Stock.

Under the terms of the Series B Preferred Stock, the Company may only declare and pay a dividend on the common stock, or repurchase shares of any such class or series of stock, if, after payment of such dividend, the dollar amount of the Company's Tier 1 Capital would be at least 90% of the Signing Date Tier 1 Capital, as set forth in the Articles Supplementary relating to the Series B Preferred Stock, excluding any subsequent net charge-offs and any redemption of the Series B Preferred Stock (the "Tier 1 Dividend Threshold"). The Tier 1 Dividend Threshold is subject to reduction, beginning on the second anniversary of issuance and ending on the tenth anniversary, by 10% for each one percent increase in QSBL over the baseline level. See "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Common Equity" at page 27 for additional information on limitations of our ability to pay dividends.

**We may issue additional equity securities, or engage in other transactions which dilute our book value or affect the priority of the common stock, which may adversely affect the market price of our common stock.**

Our board of directors may determine from time to time that we need to raise additional capital by issuing additional shares of our common stock or other securities. We are not restricted from issuing additional shares of common stock, including securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of any future offerings, or the prices at which such offerings may be affected. Such offerings, including an offering to fund the redemption of our Series B Preferred Stock, could be dilutive to common shareholders. New investors also may have rights, preferences and privileges that are senior to, and that adversely affect, our then current common shareholders. Additionally, if we raise additional capital by making additional offerings of debt or preferred equity securities, upon liquidation, holders of our debt securities and shares of preferred stock, and lenders with respect to other borrowings, will receive distributions of our available assets prior to the holders of our common stock. Additional equity offerings may dilute the holdings of our existing shareholders or reduce the market price of our common stock, or both. Holders of our common stock are not entitled to preemptive rights or other protections against dilution.

**Directors and officers of the Company own approximately 16.77% of the outstanding common stock. As a result of their combined ownership, they could make it more difficult to obtain approval for some matters submitted to shareholder vote, including acquisitions of the Company. The results of the vote may be contrary to the desires or interests of the public shareholders.**

Directors and executive officers of the Company and their affiliates own approximately 16.77% of the outstanding shares of common stock, excluding shares which may be acquired upon the exercise of options. By voting against a proposal submitted to shareholders, the directors and officers, as a group, may be able to make approval more difficult for proposals requiring the vote of shareholders, such as some mergers, share exchanges, asset sales, and amendments to the articles of incorporation.

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**Substantial regulatory limitations on changes of control and anti-takeover provisions of Maryland law may make it more difficult for you to receive a change in control premium.**

With certain limited exceptions, federal regulations prohibit a person or company or a group of persons deemed to be "acting in concert" from, directly or indirectly, acquiring more than 10% (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise direct the management or policies of our company without prior notice or application to and the approval of the Federal Reserve Board. There are comparable prior approval requirements for changes in control under Maryland law. Also, Maryland corporate law contains several provisions that may make it more difficult for a third party to acquire control of the Company without the approval of the Company's board of directors, and may make it more difficult or expensive for a third party to acquire a majority of our outstanding common stock.

**The current economic environment poses significant challenges for us and could adversely affect our financial condition and results of operations.**

The Company is operating in a challenging and uncertain economic environment. Financial institutions continue to be affected by sharp declines in the real estate market and constrained financial markets. Dramatic declines in the housing market over the past years, with falling home prices and high levels of foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions. While conditions appear to have begun to improve, generally and in the Company's market area, continued declines in real estate values, home sales volumes, and financial stress on borrowers as a result of the uncertain economic environment could have an adverse effect on our borrowers or their customers, which could adversely affect our financial condition and results of operations. A worsening of these conditions would likely exacerbate the adverse effects on us and others in the financial institutions industry. For example, further deterioration in local economic conditions in our market could drive losses beyond that which is provided for in our allowance for loan losses. The Company may also face the following risks in connection with these events:

Economic conditions that negatively affect housing prices and the job market have resulted, and may continue to result, in a deterioration in credit quality of our loan portfolios, and such deterioration in credit quality has had, and could continue to have, a negative impact on our business;

Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates on loans and other credit facilities;

The methodologies we use to establish our allowance for loan losses may no longer be reliable because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation;

Continued turmoil in the market, and loss of confidence in the banking system, could require the Bank to pay higher interest rates to obtain deposits to meet the needs of its depositors and borrowers, resulting in reduced margin and net interest income. If conditions worsen significantly, it is possible that banks such as the Bank may be unable to meet the needs of their depositors and borrowers, which could, in the worst case, result in the Bank being placed into receivership; and

Compliance with increased regulation of the banking industry may increase our costs, limit our ability to pursue business opportunities, and divert management efforts.

If these conditions or similar ones continue to exist or worsen, the Company could experience continuing or increased adverse effects on its financial condition.

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**Our financial condition and results of operations would be adversely affected if our allowance for loan losses is not sufficient to absorb actual losses or if we are required to increase our allowance for loan losses.**

Historically, we have enjoyed a relatively low level of nonperforming assets and net charge-offs, both in absolute dollars, as a percentage of loans and as compared to many of our peer institutions. As a result of this historical experience, we have incurred a relatively lower loan loss provision expense, which has positively impacted our earnings. However, experience in the banking industry indicates that a portion of our loans will become delinquent, that some of our loans may only be partially repaid or may never be repaid and we may experience other losses for reasons beyond our control. Despite our underwriting criteria and historical experience, we may be particularly susceptible to losses due to: (1) the geographic concentration of our loans, (2) the concentration of higher risk loans, such as commercial real estate, construction and commercial and industrial loans, (3) the relative lack of seasoning of certain of our loans. As a result, we may not be able to maintain our relatively low levels of nonperforming assets and charge-offs. Although we believe that our allowance for loan losses is maintained at a level adequate to absorb any inherent losses in our loan portfolio, these estimates of loan losses are necessarily subjective and their accuracy depends on the outcome of future events. If we need to make significant and unanticipated increases in our loss allowance in the future, our results of operations and financial condition would be materially adversely affected at that time.

While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any time there are loans included in the portfolio that will result in losses, but that have not been identified as nonperforming or potential problem loans. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that are identified. As a result, future additions to the allowance may be necessary.

Economic conditions and increased uncertainty in the financial markets could adversely affect ability to accurately assess our allowance for credit losses. Our ability to assess the creditworthiness of our customers or to estimate the values of our assets and collateral for loans will be reduced if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. We estimate losses inherent in our credit exposure, the adequacy of our allowance for loan losses and the values of certain assets by using estimates based on difficult, subjective, and complex judgments, including estimates as to the effects of economic conditions and how these economic conditions might affect the ability of our borrowers to repay their loans or the value of assets.

**Our continued growth depends on our ability to meet minimum regulatory capital levels. Growth and shareholder returns may be adversely affected if sources of capital are not available to help us meet them.**

As we grow, we will have to maintain our regulatory capital levels at or above the required minimum levels. If earnings do not meet our current estimates, if we incur unanticipated losses or expenses, or if we grow faster than expected, we may need to obtain additional capital sooner than not have continued access to sufficient capital, we may be required to reduce our level of assets or reduce our rate of growth in order to maintain regulatory compliance. Under those circumstances net income and the rate of growth of net income may be adversely affected. Additional issuances of equity securities could have a dilutive effect on existing shareholders.

**Our results of operations, financial condition and the value of our shares may be adversely affected if we are not able to maintain our historical growth rate.**

Since opening for business in 1998, our asset level has increased rapidly, including a 36% increase in 2011. Over the past five fiscal years (2007 - 2011), our net income has increased at a compounded annual rate of 25%, with an increase in net income of 47% in 2011. We may not be able to achieve comparable results in future years. As our asset size and earnings increase, it may become more difficult to achieve high rates of increase in assets and earnings. Additionally, it may become more difficult to achieve continued improvements in our expense levels and efficiency ratio. We may not be able to maintain the

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relatively low levels of nonperforming assets that we have experienced. Declines in the rate of growth of income or assets or deposits, and increases in operating expenses or nonperforming assets may have an adverse impact on the value of the common stock.

**We are subject to liquidity risk in our operations, which could be exacerbated if the Congress does not extend unlimited deposit insurance coverage for noninterest bearing demand deposit accounts.**

Liquidity risk is the possibility of being unable to meet obligations as they come due, pay deposits when withdrawn, and fund loan and investment opportunities as they arise because of an inability to liquidate assets or obtain adequate funding on a timely basis, at a reasonable cost and within acceptable risk tolerances. If a financial institution is unable to meet its payment obligations on a daily basis, it is subject to being placed into receivership, regardless of its capital levels. Our largest source of liquidity is customer deposit accounts, including noninterest bearing demand deposit accounts, which at December 31, 2011, constituted 29% of our total deposits.

The Dodd-Frank Act provided for temporary unlimited deposit insurance coverage for noninterest bearing demand deposit accounts through December 31, 2012, at no additional premium to the bank holding the deposit. This coverage was effective regardless of the amount of deposits maintained by a customer in the noninterest bearing demand account, or in other accounts at an insured depository institution. If Congress does not extend this unlimited deposit insurance coverage provision, then deposits in such accounts in excess of the generally applicable \$250,000 coverage limit will no longer be insured. In the absence of such insurance, customers who would have uninsured deposits may decide to move their deposits to institutions which are perceived as safer, sounder, or "too big to fail" or could elect to use other non-deposit funding products, such as repurchase agreements, that would require the Bank to pay interest and to provide securities as collateral for the Bank's repurchase obligation. At December 31, 2011, the Bank had approximately \$543 million of deposits in noninterest bearing demand accounts that would be uninsured deposits, or 23% of our total deposits.

While we believe that our strong earnings, capital position, relationship banking model and reputation as a safe and sound institution would mitigate the risk of lost deposits if unlimited insurance coverage for these accounts is not extended, there can be no assurance that that we will not have to replace a significant amount of deposits with alternative funding sources, such as repurchase agreements, federal funds lines, certificates of deposit, brokered deposits, other categories of interest bearing deposits and FHLB borrowings, all of which are more expensive than noninterest bearing deposits. While we believe that we would be able to maintain adequate liquidity at reasonable cost, the loss of a significant amount of noninterest bearing deposits could have a material adverse affect on our earnings, net interest margin, rate of growth and stock price. If unlimited deposit insurance coverage is extended on a basis that calls for additional premiums, our earnings, net interest margin, rate of growth and stock price could be adversely affected.

**We may not be able to successfully manage continued growth.**

We intend to seek further growth in the level of our assets and deposits and the number of our branches, both within our existing footprint and possibly to expand our footprint in the Maryland and Virginia suburbs, and in Washington, D.C. We may not be able to manage increased levels of assets and liabilities, and an expanded branch system, without increased expenses and higher levels of nonperforming assets. We may be required to make additional investments in equipment and personnel to manage higher asset levels and loan balances and a larger branch network, which may adversely impact earnings, shareholder returns and our efficiency ratio. Increases in operating expenses or nonperforming assets may have an adverse impact on the value of our common stock.

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**We may face risks with respect to future expansion or acquisition activity.**

We regularly seek to expand our banking operations through *de novo* branching or acquisition activities, and expect to continue to explore such opportunities. We cannot be certain that any expansion activity, through *de novo* branching, acquisition of branches of another financial institution or a whole institution, or acquisition of nonbanking financial service companies, will prove profitable or will increase shareholder value. The success of any acquisition will depend, in part, on our ability to realize the estimated cost savings and revenue enhancements from combining the businesses of the Company and the target company. Our ability to realize increases in revenue will depend, in part, on our ability to retain customers and employees, and to capitalize on existing relationships for the provision of additional products and services. If our estimates turn out to be incorrect or we are not able to successfully combine companies, the anticipated cost savings and increased revenues may not be realized fully or at all, or may take longer to realize than expected. It is possible that the integration process could result in the loss of key employees, the disruption of each company's ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with clients and employees or to achieve the anticipated benefits of the merger. As with any combination of banking institutions, there also may be disruptions that cause us to lose customers or cause customers to withdraw their deposits from our banks. Customers may not readily accept changes to their banking arrangements that we make as part of or following an acquisition. Additionally, the value of an acquisition to the Company is dependent on our ability to successfully identify and estimate the magnitude of any asset quality issues of acquired companies.

**Our concentrations of loans may create a greater risk of loan defaults and losses.**

A substantial portion of our loans are secured by real estate in the Washington, D.C. metropolitan area and substantially all of our loans are to borrowers in that area. We also have a significant amount of real estate construction loans and land related loans for residential and commercial developments. At December 31, 2011, 77% of our loans were secured by real estate, primarily commercial real estate. Management believes that the commercial real estate concentration risk is mitigated by diversification among the types and characteristics of real estate collateral properties, sound underwriting practices, and ongoing portfolio monitoring and market analysis. Of these loans, \$429.7 million, or 21% were construction and land development loans. An additional \$478.9 million, or 23% of portfolio loans, were commercial and industrial loans which are generally not secured by real estate. These categories of loans generally have a higher risk of default than other types of loans, such as single family residential mortgage loans. The repayments of these loans often depends on the successful operation of a business or the sale or development of the underlying property and as a result, are more likely to be adversely affected by adverse conditions in the real estate market or the economy in general. While we believe that our loan portfolio is well diversified in terms of borrowers and industries, these concentrations expose us to the risk that adverse developments in the real estate market, or in the general economic conditions in the Washington, D.C. metropolitan area, could increase the levels of nonperforming loans and charge-offs, and reduce loan demand. In that event, we would likely experience lower earnings or losses. Additionally, if, for any reason, economic conditions in our market area deteriorate, or there is significant volatility or weakness in the economy or any significant sector of the area's economy, our ability to develop our business relationships may be diminished, the quality and collectability of our loans may be adversely affected, the value of collateral may decline and loan demand may be reduced.

Commercial, commercial real estate and construction loans tend to have larger balances than single family mortgages loans and other consumer loans. Because the loan portfolio contains a significant number of commercial and commercial real estate and construction loans with relatively large balances, the deterioration of one or a few of these loans may cause a significant increase in nonperforming assets. An increase in nonperforming loans could result in: a loss of earnings from these loans, an increase in the provision for loan losses, or an increase in loan charge-offs, which could have an adverse impact on our results of operations and financial condition.

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Further, under guidance adopted by the federal banking regulators, banks which have concentrations in construction, land development or commercial real estate loans (other than loans for majority owner occupied properties) would be expected to maintain higher levels of risk management and, potentially, higher levels of capital. It is possible that we may be required to maintain higher levels of capital than we would otherwise be expected to maintain as a result of our levels of construction, development and commercial real estate loans, which may require us to obtain additional capital sooner than we would otherwise seek it, which may reduce shareholder returns.

Additionally, through ECV, we provide subordinated financing for the acquisition, development and construction of real estate or other projects, the primary financing for which may be provided by the Bank. These subordinated financings and the business of ECV will generally entail a higher risk profile (including lower priority and higher loan to value ratios) than loans made by the Bank. A portion of the amount which the Company expects to receive for such loans will be payments based on the success, sale or completion of the underlying project, and as such the income of the Company may be more volatile from period to period, based on the status of such projects. The Company may not be able to successfully operate or manage the business of providing higher loan to value financing.

**We may not be able to maintain growth in our Residential Lending division.**

Over the past two years, an increasing percentage of our noninterest income has been provided by the Bank's Residential Lending division, which originates residential mortgage loans on a pre-sold servicing released basis, for secondary market sale. The volume of loans originated and sold has increased from approximately \$91 million in 2009, to \$864 million in 2011. The residential mortgage business is highly competitive, and highly susceptible to changes in market interest rates, consumer confidence levels, employment statistics, the capacity and willingness of secondary market purchasers to acquire and hold or securitize loans, and other factors beyond our control. Additionally, in many respects, the mortgage origination business is relationship based, and dependent on the services of individual mortgage loan officers. The loss of services of one or more loan officers could have the effect of reducing the level of our mortgage production, or the rate of growth of production. As a result of these factors we cannot be certain that we will not be able to continue to increase the volume or percentage of revenue or net income produced by the residential mortgage business.

**Changes in interest rates and other factors beyond our control could have an adverse impact on our financial performance and results.**

Our operating income and net income depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on loans, securities and other interest bearing assets and the interest rates we pay on interest bearing deposits and other liabilities. Net interest margin is affected by changes in market interest rates, because different types of assets and liabilities may react differently, and at different times, to market interest rate changes. When interest bearing liabilities mature or re-price more quickly than interest earning assets in a period, an increase in market rates of interest could reduce net interest income. Similarly, when interest earning assets mature or re-price more quickly than interest bearing liabilities, falling interest rates could reduce net interest income. These rates are highly sensitive to many factors beyond our control, including competition, general economic conditions and monetary and fiscal policies of various governmental and regulatory authorities, including the Federal Reserve Board.

We attempt to manage our risk from changes in market interest rates by adjusting the rates, maturity, re-pricing, and balances of the different types of interest earning assets and interest bearing liabilities, but interest rate risk management techniques are not exact. As a result, a rapid increase or decrease in interest rates could have an adverse effect on our net interest margin and results of operations. At December 31, 2011, our cumulative net asset sensitive twelve month gap position was 14.38% of total assets, which includes loans currently at their floor rates. As such, we expect modest increases of approximately 0.8% and 2.2%, respectively, in projected net interest income and net income over a twelve month period resulting from a 100 basis point increase in rates, as loans currently at floor rates which are above the

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calculated contractual rate do not adjust upon a rate increase. The results of our interest rate sensitivity simulation model depend upon a number of assumptions which may not prove to be accurate. There can be no assurance that we will be able to successfully manage our interest rate risk. Increases in market rates and adverse changes in the local residential real estate market, the general economy or consumer confidence would likely have a significant adverse impact on our noninterest income, as a result of reduced demand for residential mortgage loans, which we make on a pre-sold basis.

Adverse changes in the real estate market in our market area could also have an adverse affect on our cost of funds and net interest margin, as we have a large amount of noninterest bearing deposits related to real estate sales and development. While we expect that we would be able to replace the liquidity provided by these deposits, the replacement funds would likely be more costly, negatively impacting earnings.

Changes in laws, including those that permit banks to pay interest on checking and demand deposit accounts established by businesses commencing in July 2011, could have a significant negative effect on net interest income, net income, net interest margin, return on assets and return on equity. At December 31, 2011, 29% of our deposits were noninterest bearing demand deposits.

**We may not be able to successfully compete with others for business.**

The Washington, D.C. metropolitan area in which we operate is considered highly attractive from an economic and demographic viewpoint, and is a highly competitive banking market. We compete for loans, deposits, and investment dollars with numerous regional and national banks, online divisions of out-of-market banks, and other community banking institutions, as well as other kinds of financial institutions and enterprises, such as securities firms, insurance companies, savings associations, credit unions, mortgage brokers, and private lenders. Many competitors have substantially greater resources than us, and operate under less stringent regulatory environments. The differences in resources and regulations may make it harder for us to compete profitably, reduce the rates that we can earn on loans and investments, increase the rates we must offer on deposits and other funds, and adversely affect our overall financial condition and earnings.

The Company has been very successful in developing new customer relationships by capitalizing on the reluctance of many large regional and nationwide banks to lend over the past several years, and the demise of the commercial mortgage backed securities market and other nonbank sources of financing. These new relationships have resulted in significant increases in both loans and deposits, and have contributed to increased earnings. As the economy improves and these competitors, many of which have access to cheaper sources of funding than the Company, recommence lending, we may not be able to retain the loans and deposits produced by these new relationships. While we believe that our relationship banking model will enable us to keep a significant percentage of these new relationships, there can be no assurance that we will be able to do so, that we would be able to maintain favorable pricing, margins and asset quality, or that we will be able to grow at the same rate we did when such alternative financing was not widely available.

**Government regulation will significantly affect the Bank's business, and may result in higher costs and lower shareholder returns.**

The banking industry is heavily regulated. Banking regulations are primarily intended to protect the federal deposit insurance funds and depositors, not shareholders. The Company and Bank are regulated and supervised by the Maryland Department of Financial Regulation, the Federal Reserve Board and the FDIC. The burden imposed by federal and state regulations puts banks at a competitive disadvantage compared to less regulated competitors such as finance companies, mortgage banking companies and leasing companies. Changes in the laws, regulations and regulatory practices affecting the banking industry may increase our costs of doing business or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition. Federal economic and monetary policy may also affect our ability to attract deposits and other funding sources, make loans and investments, and achieve satisfactory interest spreads.

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**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None

**ITEM 2. PROPERTIES**

All properties out of which the Company operates are leased properties. As of December 31, 2011, the Company and its subsidiaries operated out of 18 leased facilities; 15 of which are leased for branch offices in the Washington, DC metro area: seven in Montgomery County, Maryland; five located in the District of Columbia; and three Northern Virginia.

The Bank opened its sixteenth branch office in Reston, Virginia near Reston Town Center in February 2012, and has announced an additional office projected to open in Merrifield, Virginia in the Fall of 2012.

**Maryland Branch Locations:**

Bethesda Main Office  
7815 Woodmont Avenue  
Bethesda, Maryland 20814

Chevy Chase Office  
15 Wisconsin Circle  
Chevy Chase, Maryland 20815

Park Potomac Office  
12505 Park Potomac Avenue  
Potomac, Maryland 20854

Rockville Office  
110 North Washington Street  
Rockville, Maryland 20850

Rollins Avenue Office  
130 Rollins Avenue  
Rockville, Maryland 20852

Shady Grove Office  
9600 Blackwell Road  
Rockville, Maryland 20850

Silver Spring Office  
8665-B Georgia Avenue  
Silver Spring, Maryland 20910

**Virginia Branch Locations:**

Ballston Office  
4420 N. Fairfax Drive  
Arlington, Virginia 22203

Merrifield Office(1)  
2905 District Avenue  
Fairfax, Virginia 22201

Reston Office(2)  
12011 Sunset Hills Road  
Reston, Virginia 20190

Rosslyn Office  
1919 N. Lynn Street  
Arlington, Virginia 22209

Tysons Corner Office  
8601 Westwood Center Drive  
Vienna, Virginia 22182

**Washington, DC Branch Locations:**

Dupont Circle Office  
1228 Connecticut Avenue, NW  
Washington, DC 20036

Gallery Place Office  
700 7th Street, NW  
Washington, DC 20001

Georgetown Office  
1044 Wisconsin Avenue, NW  
Washington, DC 20007

K Street Office  
2001 K Street, NW  
Washington, DC 20006

McPherson Square Office  
1425 K Street, NW  
Washington, DC 20005

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(1) Opens fall 2012  
(2) Opened February 2012

Operations and executive administration accounted for an additional three offices. The executive offices for the Bank and the Company are located adjacent to the Main Office branch at 7809 Woodmont



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Avenue, Bethesda, Maryland. The Lending Operations Center is located at 7830 Old Georgetown Road, and the Operations Center is located at 11961 Tech Road, Silver Spring, Maryland.

In June 2003, the Company occupied an additional office facility in Bethesda at 7819 Norfolk Avenue, consisting of 2,820 square feet under a ten year lease (with options) which expires in May 2013. This facility is currently under a sub-lease arrangement which runs concurrent to the lease expiration in May 2013.

**Other Properties:**

Executive Offices  
7809 Woodmont Avenue  
Bethesda, Maryland 20814

Reston Office  
11911 Freedom Drive  
Reston, Virginia 20190

Lending Center  
7830 Old Georgetown Road  
Bethesda, Maryland 20814

7819 Norfolk Avenue  
Bethesda, Maryland 20814

Operations Center  
11961 Tech Road  
Silver Spring, Maryland 20904

Additional leased space related to the Company's residential lending line of businesses either have been or are being opened in 2012. The Anne Arundel County Office located at 808 Landmark Drive, Suite 221, was opened in March 2012. The Reston property located at 12011 Sunset Hills Drive was opened in February 2012.

**Residential Lending:**

Anne Arundel County Office  
808 Landmark Drive, Suite 221  
Glen Burnie, Maryland 21061

Reston Office Residential Lending  
12011 Sunset Hills Drive  
Reston, Virginia 20190

Park Potomac office Fifth Floor  
12505 Park Potomac Avenue  
Potomac, Maryland 20854

**ITEM 3. LEGAL PROCEEDINGS**

From time to time the Company is a participant in various legal proceedings incidental to its business. In the opinion of management, the liabilities (if any) resulting from such legal proceedings will not have a material effect on the financial position of the Company.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF COMMON EQUITY**

*Market for Common Stock.* The Company's common stock is listed for trading on the NASDAQ Capital Market under the symbol "EGBN." Over the twelve month period ended December 31, 2011, the average daily trading volume amounted to approximately 49,113 shares, an increase from approximately 46,500 shares over the twelve month period ended December 31, 2010. No assurance can be given that a highly active trading market will develop or can be maintained. The following table sets forth the high and low sale prices for the common stock during each calendar quarter during the last two fiscal years. No dividends for common shareholders were declared during such periods. As of March 4, 2012, there were 20,212,835 shares of common stock outstanding, held by approximately 2,900 beneficial shareholders, including approximately 982 shareholders of record.

Quarter	2011		2010	
	High	Low	High	Low
First	\$ 15.14	\$ 13.00	\$ 12.98	\$ 9.90
Second	\$ 14.50	\$ 11.80	\$ 14.49	\$ 11.06
Third	\$ 14.55	\$ 11.10	\$ 12.25	\$ 10.25
Fourth	\$ 15.10	\$ 11.26	\$ 14.89	\$ 10.95

*Dividends.* The Company has not paid a cash dividend on the common stock since the second quarter of 2008, after which the dividend was discontinued in order to conserve capital.

The resumption of payment of a cash dividend on common stock will depend largely upon the ability of the Bank, the Company's principal operating business, to declare and pay dividends to the Company. Resumption of dividends on the common stock will also depend upon the Bank's earnings, financial condition, and need for funds, as well as governmental policies and regulations applicable to the Company and the Bank.

Regulations of the Federal Reserve Board and Maryland law place limits on the amount of dividends the Bank may pay to the Company without prior approval. Prior regulatory approval is required to pay dividends which exceed the Bank's net profits for the current year plus its retained net profits for the preceding two calendar years, less required transfers to surplus. Under Maryland law, dividends may only be paid out of retained earnings. State and federal bank regulatory agencies also have authority to prohibit a bank from paying dividends if such payment is deemed to be an unsafe or unsound practice, and the Federal Reserve Board has the same authority over bank holding companies. At December 31, 2011 the Bank could pay dividends to the Company to the extent of its earnings so long as it maintained required capital ratios.

The Federal Reserve Board has established guidelines with respect to the maintenance of appropriate levels of capital by registered bank holding companies. Compliance with such standards, as presently in effect, or as they may be amended from time to time, could possibly limit the amount of dividends that the Company may pay in the future. In 1985, the Federal Reserve Board issued a policy statement on the payment of cash dividends by bank holding companies. In the statement, the Federal Reserve Board expressed its view that a holding company experiencing earnings weaknesses should not pay cash dividends exceeding its net income, or which could only be funded in ways that weaken the holding company's financial health, such as by borrowing. As a depository institution, the deposits of which are insured by the FDIC, the Bank may not pay dividends or distribute any of its capital assets while it remains in default on any assessment due the FDIC. The Bank currently is not in default under any of its obligations to the FDIC. Refer to above discussion on conditions precedent to resuming the payment of the cash common stock dividend.

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The Company's ability to pay dividends on the common stock is also restricted by the provisions of the Series B Preferred Stock issued under the SBLF. Under the Series B Preferred Stock, no repurchases may be effected, and no dividends may be declared or paid on preferred shares ranking *pari passu* with the Series B Preferred Stock, junior preferred shares, or other junior securities (including the common stock) during the current quarter and for the next three quarters following the failure to declare and pay dividends on the Series B Preferred Stock, except that, in any such quarter in which the dividend is paid, dividend payments on shares ranking *pari passu* may be paid to the extent necessary to avoid any resulting material covenant breach.

Under the terms of the Series B Preferred Stock, the Company may only declare and pay a dividend on the common stock or other stock junior to the Series B Preferred Stock, or repurchase shares of any such class or series of stock, if, after payment of such dividend, the dollar amount of the Company's Tier 1 Capital would be at least 90% of the Signing Date Tier 1 Capital, as set forth in the Articles Supplementary relating to the Series B Preferred Stock, excluding any subsequent net charge-offs and any redemption of the Series B Preferred Stock (the "Tier 1 Dividend Threshold"). The Tier 1 Dividend Threshold is subject to reduction, beginning on the second anniversary of issuance and ending on the tenth anniversary, by 10% for each one percent increase in QSBL over the baseline level.

*Issuer Repurchase of Common Stock.* No shares of the Company's Common Stock were repurchased by or on behalf of the Company during 2011 or 2010.

*Internet Access to Company Documents.* The Company provides access to its SEC filings through its web site at [www.eaglebankcorp.com](http://www.eaglebankcorp.com) by linking to the SEC's web site. After accessing the web site, the filings are available upon selecting "Investor Relations SEC Filings." Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed with or furnished to the SEC.

See Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters for "Securities Authorized for Issuance Under Equity Compensation Plans."

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*Stock Price Performance.* The following table compares the cumulative total return on a hypothetical investment of \$100 in the Company's common stock on December 31, 2006 through December 31, 2011, with the hypothetical cumulative total return on the NASDAQ Stock Market Index (U.S. Companies) and the NASDAQ Bank Index for the comparable period, including reinvestment of dividends.

**Total Return Performance**

Index	Period Ending					
	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Eagle Bancorp, Inc.	100.00	70.68	37.35	68.00	93.73	94.44
NASDAQ Stock Market Index-(U.S. Companies)	100.00	110.66	66.42	96.54	114.06	113.16
NASDAQ Bank Index	100.00	80.09	62.84	52.60	60.04	53.74

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

The following table shows selected historical consolidated financial data for the Company. It should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this report.

*Use of Non-GAAP Financial Measures*

The information set forth below contains certain financial information determined by methods other than in accordance with generally accepted accounting principles in the United States ("GAAP"). These non-GAAP financial measures are "tangible common equity," and "tangible book value per common share." Our management uses these non-GAAP measures in its analysis of our performance because it believes these measures are material and will be used as a measure of our performance by investors.

These disclosures should not be considered in isolation or as a substitute for results determined in accordance with GAAP, and are not necessarily comparable to non-GAAP performance measures which may be presented by other bank holding companies. Management compensates for these limitations by providing detailed reconciliations between GAAP information and the non-GAAP financial measures. A reconciliation table is set forth below following the selected historical consolidated financial data.

(dollars in thousands except per share data)	Year ended December 31,				
	2011	2010	2009	2008	2007
<b><i>Balance Sheet Period End</i></b>					
Securities	\$ 324,053	\$ 237,576	\$ 245,644	\$ 169,079	\$ 87,117
Loans held for sale	176,826	80,571	1,550	2,718	2,177
Loans	2,056,256	1,675,500	1,399,311	1,265,640	716,677
Allowance for credit losses	29,653	24,754	20,619	18,403	8,037
Intangible assets, net	4,145	4,188	4,379	2,533	236
Total assets	2,831,255	2,089,370	1,805,504	1,496,827	846,400
Deposits	2,392,095	1,726,798	1,460,274	1,129,380	630,936
Borrowings	152,662	146,884	150,090	215,952	128,408
Total liabilities	2,564,544	1,884,654	1,617,183	1,354,456	765,234
Preferred stockholders' equity	56,600	22,582	22,612	36,312	
Common stockholders' equity	210,111	182,134	165,709	106,059	81,166
Total stockholders' equity	266,711	204,716	188,321	142,371	81,166
Tangible common equity(1)	205,966	177,946	161,330	103,526	80,930
<b><i>Statement of Operations</i></b>					
Interest income	\$ 119,124	\$ 96,658	\$ 84,338	\$ 65,657	\$ 57,077
Interest expense	20,077	19,832	24,809	23,676	23,729
Provision for credit losses	10,983	9,308	7,669	3,979	1,643
Noninterest income	13,501	9,242	7,297	4,366	5,186
Noninterest expense	63,276	51,005	42,773	30,817	24,921
Income before taxes	38,289	25,755	16,384	11,551	11,970
Income tax expense	13,731	9,098	5,965	4,123	4,269
Net income	24,558	16,657	10,419	7,428	7,701
Preferred dividends	1,511	1,299	2,307	177	
Net income available to common shareholders	23,047	15,358	8,112	7,251	7,701

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	Year ended December 31,				
(dollars in thousands except per share data)	2011	2010	2009	2008	2007
<b>Per Common Share Data(2)</b>					
Net income, basic	\$ 1.16	\$ 0.78	\$ 0.55	\$ 0.63	\$ 0.73
Net income, diluted	1.14	0.77	0.55	0.62	0.71
Dividends declared				0.11	0.22
Book value	10.53	9.25	8.48	8.34	7.59
Tangible book value(3)	10.32	9.03	8.26	8.14	7.57
Common shares outstanding	19,952,844	19,700,387	19,534,226	12,714,355	10,693,447
Weighted average common shares outstanding	19,835,534	19,648,591	14,643,294	11,556,569	10,531,236
<b>Ratios</b>					
Net interest margin(5)	3.99%	4.09%	3.85%	4.05%	4.37%
Efficiency ratio(4)	56.22%	59.26%	64.01%	66.49%	66.54%
Return on average assets(5)	0.97%	0.86%	0.65%	0.69%	0.96%
Return on average common equity	11.71%	8.74%	6.52%	8.04%	10.03%
Total capital (to risk weighted assets)	11.84%	11.64%	13.57%	11.93%	11.21%
Tier 1 capital (to risk weighted assets)	10.33%	9.91%	11.82%	9.78%	10.20%
Tier 1 capital (to average assets)	8.21%	9.32%	10.29%	9.22%	9.46%
<b>Asset Quality</b>					
Nonperforming assets and loans 90+ past due	\$ 36,019	\$ 31,988	\$ 27,131	\$ 26,366	\$ 5,324
Nonperforming assets and loans 90+ past due to total assets	1.27%	1.53%	1.50%	1.76%	0.63%
Allowance for credit losses to loans	1.44%	1.48%	1.47%	1.45%	1.12%
Allowance for credit losses to nonperforming assets	82.33%	77.39%	76.00%	69.80%	150.96%
Net charge-offs	\$ 6,084	\$ 5,172	\$ 5,454	\$ 1,123	\$ 979
Net charge-offs to average loans	0.32%	0.35%	0.42%	0.12%	0.15%

- (1) Tangible common shareholders' equity, a non-GAAP financial measure, is defined as total common shareholders' equity reduced by goodwill and other intangible assets.
- (2) Presented giving retroactive effect to the 10% stock dividend paid on the common stock on October 1, 2008. In July 2008, the Company discontinued the payment of its quarterly cash dividend.
- (3) Tangible book value per common share, a non-GAAP financial measure, is defined as tangible common shareholders' equity divided by total common share outstanding.
- (4) Computed by dividing noninterest expense by the sum of net interest income and noninterest income.

	Year ended December 31,				
(dollars in thousands except per share data)	2011	2010	2009	2008	2007
<b>GAAP Reconciliation</b>					
Common stockholders' equity	\$ 210,111	\$ 182,134	\$ 165,709	\$ 106,059	\$ 81,166
Less: Intangible assets	(4,145)	(4,188)	(4,379)	(2,533)	(236)
<b>Tangible common equity</b>	<b>\$ 205,966</b>	<b>\$ 177,946</b>	<b>\$ 161,330</b>	<b>\$ 103,526</b>	<b>\$ 80,930</b>
Book value per common share	\$ 10.53	\$ 9.25	\$ 8.48	\$ 8.34	\$ 7.59
Less: Intangible book value per common share	(0.21)	(0.22)	(0.22)	(0.20)	(0.02)
<b>Tangible book value per common share</b>	<b>\$ 10.32</b>	<b>\$ 9.03</b>	<b>\$ 8.26</b>	<b>\$ 8.14</b>	<b>\$ 7.57</b>

(5)

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The reported figure includes the effect of a \$618 million deposit received on September 13, 2011 in connection with a class action settlement, which was disbursed by year end. The deposit was invested in excess reserves at the Federal Reserve Bank. As the magnitude of the deposit distorts the operational results of the Company, we present in the GAAP reconciliation below and in Management's Discussion and Analysis of Financial Condition and Results of Operations, certain performance ratios notably the net interest margin and the return on average assets excluding the effect of this deposit, which resulted in approximately \$254,000 and \$326,000 of interest income and \$140,000 and \$170,000 of income, net of tax, during the three and twelve months periods ended December 31, 2011. We believe this information is important to enable shareholders and other interested parties to assess the core operational performance of the Company.

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GAAP Reconciliation (dollars in thousands except per share data)	Twelve Months Ended December 31,					
	2011			2010		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Total interest earning assets	\$ 2,482,625	\$ 119,124	4.80%	\$ 1,877,151	\$ 96,658	5.15%
Less: settlement deposit(5)	(117,990)	(326)	(0.28)%			
Adjusted interest earning assets	\$ 2,364,635	\$ 118,798	5.02%	\$ 1,877,151	\$ 96,658	5.15%
Total interest bearing liabilities	\$ 1,679,855	\$ 20,077	1.20%	\$ 1,396,216	\$ 19,832	1.42%
<b>Adjusted interest spread</b>			<b>3.82%</b>			<b>3.73%</b>
<b>Adjusted interest margin</b>			<b>4.17%</b>			<b>4.09%</b>

	Three Months Ended December 31,					
	2011			2010		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Total interest earning assets	\$ 3,071,903	\$ 33,091	4.27%	\$ 2,021,492	\$ 26,040	5.11%
Less: settlement deposit(5)	(396,710)	(254)	(0.25)%			
Adjusted interest earning assets	\$ 2,675,193	\$ 32,837	4.87%	\$ 2,021,492	\$ 26,040	5.11%
Total interest bearing liabilities	\$ 1,858,912	\$ 4,820	1.03%	\$ 1,469,085	\$ 4,753	1.28%
<b>Adjusted interest spread</b>			<b>3.84%</b>			<b>3.83%</b>
<b>Adjusted interest margin</b>			<b>4.15%</b>			<b>4.18%</b>

(dollars in thousands except per share data)	December 31,		December 31,	
	2011 (Unaudited)	2010 (Unaudited)	2011 (Unaudited)	2010 (Unaudited)
Net income	\$ 24,558	\$ 16,657	\$ 7,174	\$ 5,054
Less: settlement deposit(5)	(326)		(254)	
Adjusted net income	\$ 24,232	\$ 16,657	\$ 6,920	\$ 5,054
Average total assets	2,523,592	1,936,191	3,111,952	2,079,392
Less: settlement deposit	(117,990)		(396,710)	
Adjusted average total assets	2,405,602	1,936,191	2,715,242	2,079,392
<b>Adjusted return on average assets</b>	<b>1.01%</b>	<b>0.86%</b>	<b>1.01%</b>	<b>0.96%</b>

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**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of the Company. The Company's primary subsidiaries are the Bank, Bethesda Leasing, LLC, Eagle Insurance Services, LLC, and Eagle Commercial Ventures ("ECV"). This discussion and analysis should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto, appearing elsewhere in this report.

*Caution About Forward Looking Statements.* This report contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, objectives, expected operating results and the assumptions upon which those statements are based. Forward looking statements include without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and are typically identified with words such as "may," "could," "should," "will," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan," or words or phrases of similar meaning. These forward looking statements are based largely on our expectations and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are, in many instances, beyond our control. Actual results, performance or achievements could differ materially from those contemplated, expressed, or implied by the forward looking statements.

The following factors, among others, could cause our financial performance to differ materially from that expressed in such forward looking statements:

The strength of the United States economy in general and the strength of the local economies in which we conduct operations;

Geopolitical conditions, including acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and/or military conflicts, which could impact business and economic conditions in the United States and abroad;

The effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board, inflation, interest rate, market and monetary fluctuations;

The timely development of competitive new products and services and the acceptance of these products and services by new and existing customers;

The willingness of users to substitute competitors' products and services for our products and services;

The impact of changes in financial services policies, laws and regulations, including laws, regulations and policies concerning taxes, banking, securities and insurance, and the application thereof by regulatory bodies;

The effect of changes in accounting policies and practices, as may be adopted from time-to-time by bank regulatory agencies, the Securities and Exchange Commission (the "SEC"), the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;

Technological changes;

The effect of acquisitions we may make, including, without limitation, the failure to achieve the expected revenue growth and/or expense savings from such acquisitions;

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The growth and profitability of non-interest or fee income being less than expected;

Changes in the level of our nonperforming assets and charge-offs;

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Changes in consumer spending and savings habits; and

Unanticipated regulatory or judicial proceedings.

If one or more of the factors affecting our forward looking information and statements proves incorrect, then our actual results, performance or achievements could differ materially from those expressed in, or implied by, forward looking information and statements contained in this report. You should not place undue reliance on our forward looking information and statements. We will not update the forward looking statements to reflect actual results or changes in the factors affecting the forward looking statements.

**GENERAL**

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The Company is a growth oriented, one-bank holding company headquartered in Bethesda, Maryland. The Company provides general commercial and consumer banking services through the Bank, its wholly owned banking subsidiary, a Maryland chartered bank which is a member of the Federal Reserve System. The Company was organized in October 1997, to be the holding company for the Bank. The Bank was organized as an independent, community oriented, full service banking alternative to the super regional financial institutions, which dominate the primary market area. The Company's philosophy is to provide superior, personalized service to its customers. The Company focuses on relationship banking, providing each customer with a number of services, becoming familiar with and addressing customer needs in a proactive, personalized fashion. The Bank currently has a total of sixteen offices, including seven offices serving Montgomery County, Maryland, five offices in the District of Columbia and four offices in Arlington and Fairfax Counties in Virginia. The Company has announced plans to open an additional office in Merrifield, Virginia, which is expected to open in the fall of 2012.

The Company offers a broad range of commercial banking services to its business and professional clients as well as full service consumer banking services to individuals living and/or working primarily in the Bank's market area. The Company emphasizes providing commercial banking services to sole proprietors, small and medium-sized businesses, partnerships, corporations, non-profit organizations and associations, and investors living and working in and near the primary service area. These services include the usual deposit functions of commercial banks, including business and personal checking accounts, "NOW" accounts and money market and savings accounts, business, construction, and commercial loans, residential mortgages and consumer loans, and cash management services. The Bank is also active in the origination and sale of residential mortgage loans and the origination of small business loans. The residential mortgage loans are originated for sale to third-party investors, generally large mortgage and banking companies, under firm commitments by the investors to purchase the loans subject to compliance with pre-established investor criteria. The Company generally sells the insured portion of the loan generating noninterest income from the gains on sale as well as servicing income on the portion participated. Bethesda Leasing, LLC, a subsidiary of the Bank, holds title to and manages Other Real Estate Owned ("OREO") assets. Eagle Insurance Services, LLC, a subsidiary of the Bank, offers access to insurance products and services through a referral program with a third party insurance broker. Additionally, the Bank offers investment advisory services through a referral program with a third party. ECV, a subsidiary of the Company, provides subordinated financing for the acquisition, development and construction of real estate projects. This lending involves higher levels of risk, together with commensurate expected returns.

In spite of the official measures of economic activity signaling an end to the recession in June 2010, generally weak economic conditions persisted in the U.S. economy throughout 2011, with unemployment levels remaining high, real estate values remaining a concern, home foreclosure problems, and personal income levels being only modestly higher. Average interest rates during 2011 declined as compared to 2010, in part due to the Federal Reserve's quantitative easing program involving large purchases of mortgaged backed securities. These purchases served to lower residential mortgage interest rates to

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all-time lows, in the hope that more homeowners might benefit from refinancing existing home mortgages. The Company's primary market, the Washington, D.C. metropolitan area, has been relatively less impacted by the severe recessionary climate than other parts of the country, due in part to the significant economic impact of the federal government, a highly educated work force and a diverse economy.

The slowdown in the economy was less severe in the Company's marketplace than many other areas of the country, and has to a lesser extent impacted the Company's customers and business. The Company has had the resources and has remained committed to meeting the credit needs of its community, resulting in continued growth in its loan portfolio during 2011. Furthermore, the Company's capital position was enhanced in 2011 due its participation in the SBLF. The SBLF preferred stock carries a lower dividend rate than preferred stock under the Troubled Asset Relief Program Capital Purchase Program ("TARP CPP"), which was redeemed during 2011. The Company believes its strategies of remaining growth oriented and seeking quality lending and deposit relationships during the difficult economic times of the past few years has proven successful and is evidenced in all its financial and performance ratios. Additionally, the Company believes such focus and strategy of relationship building has fostered future growth opportunities.

In this less than ideal operating environment, the Company was able to produce increased earnings in each quarter of 2011, continuing a trend of twelve quarters of increasing net income through the fourth quarter of 2011. The Company averted pitfalls which beleaguered many financial institutions. It did not make subprime residential mortgage loans to retail customers, did not invest in private label mortgage backed securities, securities backed by subprime or Alt A mortgages, and was not a major lender to home builders, factors which have negatively impacted many banking companies throughout the U.S and the region.

**CRITICAL ACCOUNTING POLICIES**

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The Company's consolidated financial statements are prepared in accordance with GAAP and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or a valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility.

The fair values and the information used to record valuation adjustments for investment securities available for sale are based either on quoted market prices or are provided by other third-party sources, when available. The Company's investment portfolio is categorized as available for sale with unrealized gains and losses net of income tax being a component of shareholders' equity and accumulated other comprehensive income.

The allowance for credit losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two principles of accounting: (a) ASC Topic 450, "*Contingencies*," which requires that losses be accrued when they are probable of occurring and are estimable and (b) ASC Topic 310, "*Receivables*," which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any,

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can be determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows, or values observable in the secondary markets.

Three components comprise our allowance for credit losses: a specific allowance, a formula allowance and a nonspecific or environmental factors allowance. Each component is determined based on estimates that can and do change when actual events occur.

The specific allowance allocates a reserve to identified impaired loans. Impaired loans are assigned specific reserves based on an impairment analysis. Under ASC Topic 310, "*Receivables*," a loan for which reserves are individually allocated may show deficiencies in the borrower's overall financial condition, payment record, support available from financial guarantors and for the fair market value of collateral. When a loan is identified as impaired, a specific reserve is established based on the Company's 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 requiring specific reserves. The portfolio of unimpaired loans is stratified by loan type and risk assessment. Allowance factors relate to the type of loan and level of the internal risk rating, with loans exhibiting higher risk and loss experience receiving a higher allowance factor.

The environmental allowance is also used to estimate the loss associated with pools of non-classified loans. These non-classified loans are also stratified by loan type, and environmental allowance factors are assigned by management based upon a number of conditions, including delinquencies, loss history, changes in lending policy and procedures, changes in business and economic conditions, changes in the nature and volume of the portfolio, management expertise, concentrations within the portfolio, quality of internal and external loan review systems, competition, and legal and regulatory requirements.

The allowance captures losses inherent in the portfolio which have not yet been recognized. Allowance factors and the overall size of the allowance may change from period to period based upon management's assessment of the above described factors, the relative weights given to each factor, and portfolio composition.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses, including, in connection with the valuation of collateral, a borrower's prospects of repayment, and in establishing allowance factors on the formula and environmental components of the allowance. The establishment of allowance factors involves a continuing evaluation, based on management's ongoing assessment of the global factors discussed above and their impact on the portfolio. The 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 can have a direct impact on the amount of the provision, and a related after tax effect on net income. Errors in management's perception and assessment of the global 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. Alternatively, errors in management's perception and assessment of the global factors and their impact on the portfolio could result in the allowance being in excess of amounts necessary to cover losses in the portfolio, and may result in lower provisions in the future. For additional information regarding the provision for credit losses, refer to the discussion under the caption "Provision for Credit Losses" below.

The Company follows the provisions of ASC Topic 718, "*Compensation*," which requires the expense recognition for the fair value of share based compensation awards, such as stock options, restricted stock awards, and performance based shares. This standard allows management to establish modeling assumptions as to expected stock price volatility, option terms, forfeiture rates and dividend rates which directly impact estimated fair value. The accounting standard also allows for the use of alternative option pricing models which may impact fair value as determined. The Company's practice is to utilize reasonable and supportable assumptions.

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**RESULTS OF OPERATIONS**

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**Overview**

In mid September 2011, the Bank became the depository for an approximately \$618 million noninterest bearing escrow deposit relating to a large class action lawsuit settlement (the "settlement deposit"). Due to the expected short-term nature of these funds, they were invested in excess reserves at the Federal Reserve Bank. These funds, as expected, were disbursed to other financial institutions before year-end 2011. We estimate that these funds contributed approximately \$140 thousand to net earnings in the fourth quarter of 2011 and \$170 thousand to earnings for the full year 2011. The funds are expected to be re-deposited with EagleBank for disbursement to claim holders in 2012. These funds positively impacted net earnings but had a substantial negative impact on our net interest margin and return on assets for the fourth quarter and full year 2011. Therefore, the discussion below also reflects our results of operation excluding the settlement deposit, on a non-GAAP basis, which management feels is more comparable to prior period results. The reconciliation of the various non-GAAP measures is included elsewhere in at Item 6 of this report.

For the year and fourth quarter of 2011, the Company recognized one-time charges relating to a merger transaction that was terminated in the fourth quarter which had a pretax cost of \$733 thousand and \$400 thousand, respectively. In addition, for the year of 2011 the Company recognized one-time charges relating to conversion costs and special marketing expenses which had a pretax cost of \$554 thousand and \$296 thousand, respectively. These items negatively impacted the year and fourth quarter after tax earnings by \$1.0 million (\$0.05 per share) and \$240 thousand (\$0.01 per share), respectively.

For the year ended December 31, 2011, the Company's net income was a record \$24.6 million, a 47% increase over the \$16.7 million for the year ended December 31, 2010 as compared to \$10.4 million for the year ended December 31, 2009. The increase in net income for the twelve months ended December 31, 2011 can be attributed primarily to an increase in net interest income of 29% as compared to the same period in 2010. Net interest income growth was due substantially to growth in average earning assets of 32% in 2011.

Net income available to common shareholders was \$23.0 million (\$1.16 per basic common share and \$1.14 per diluted common share), as compared to \$15.4 million (\$0.78 per basic common share and \$0.77 per diluted common share) for the year ended December 31, 2010, a 50% increase. The higher percentage increase in net income available to common shareholders versus net income is due to a lower dividend rate on preferred stock acquired from the SBLF program as opposed to preferred stock from the TARP CPP which was fully redeemed in 2011.

For the three months ended December 31, 2011, the Company reported net income of \$7.2 million as compared to \$5.1 million for the same period in 2010. Earnings per basic share were \$0.35 for the three months ended December 31, 2011, as compared to \$0.24 for 2010. Earnings per diluted common shares were \$0.35 for the three months ended December 31, 2011 and \$0.23 for the same period in 2010.

The Company had a return on average assets of 0.97% (1.01% excluding the effect of the settlement deposit) as compared to 0.86% for the year 2010, while the return of average common equity was 11.71% in 2011, as compared to 8.74% for the year 2010. The increase in these ratios was due to a combination of an increase in the net interest margin (excluding the settlement deposit), resulting primarily from lower funding costs; lower credit losses as a percentage of loans, increases in noninterest income, improved operating efficiency and, in the case of the return on average common equity, additional balance sheet leverage.

The Company's earnings are largely dependent on net interest income, which represented 88% and 89% of total revenue (defined as net interest income plus non interest income) for the full year in 2011 and 2010, respectively. For the twelve months ended December 31, 2011, the net interest margin, which measures the difference between interest income and interest expense (i.e. net interest income) as a

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percentage of earning assets was 3.99% (4.17% excluding the settlement deposit) as compared to 4.09% for the twelve months ended December 31, 2010. The higher margin for 2011 (excluding the settlement deposit) as compared to 2010 was due to maintaining loan yields close to 2010 levels and reducing funding costs while maintaining a favorable deposit mix; much of which has occurred from efforts to increase and deepen client relationships.

Excluding the settlement deposit, the higher margin for the year ended 2011 as compared to the same period of 2010 was due primarily to lower funding costs for both deposits and borrowings more than offsetting a decline in earning asset yields. Average loan yields declined by 7 basis points (from 5.87% to 5.80%), average investment yields declined by 37 basis points (from 2.69% to 2.32%), and average earning asset yields declined by 35 basis points (from 5.15% to 4.80%) as compared to a decline of 22 basis points (from 1.42% to 1.20%) in the cost of interest bearing liabilities. Importantly, a higher mix of average loans and average loans held for sale as a percentage of total earning assets (from 82% to 83%) during the year ended December 31, 2011, as compared to the same period in 2010, mitigated the decline in the average earning asset yield. The net interest spread was 3.82% for the year ended December 31, 2011, as compared to 3.73% for the same period in 2010, an increase of 9 basis points. The benefit of noninterest sources funding earning assets declined from 36 basis points for the year ended December 31, 2010 to 35 basis points for same period in 2011.

Including the effect of the settlement deposit the margin decreased from 4.09% for the year ended December 31, 2010 to 3.99% for the same period in 2011. Including the effect of the settlement deposit, the net interest spread was 3.60% for the year ended December 31, 2011, as compared to 3.73% for the same period in 2010, a decrease of 13 basis points. Including the effect of the settlement deposit, the benefit of noninterest sources funding earning assets increased from 36 basis points for the year ended December 31, 2010 to 39 basis points for same period in 2011. The combination of a 13 basis point decline in the net interest spread and 3 basis points increase in the value of noninterest sources resulted in the 10 basis point decrease in the net interest margin.

Excluding the effect of the settlement deposit, for the three months ended December 31, 2011 and 2010, average interest bearing liabilities were 70% and 73%, respectively, of average earning assets, as more earning assets were funded by noninterest bearing sources in the most recent three month period as compared to the same three month period in 2010. Additionally, due to a lower mix of average loans in the three months ended December 31, 2011, as compared to the same period in 2010 (from 80% to 76%), the average rate on earning assets for the three months ended December 31, 2011 decreased by 24 basis points from 5.11% to 4.87%. The cost of interest bearing liabilities for the three months ended December 31, 2011 as compared to 2010 decreased by 25 basis points from 1.28% to 1.03%, resulting in an increase in the net interest spread of 1 basis point from 3.83% for the three months ended December 31, 2010 to 3.84% for the three months ended December 31, 2011. The net interest margin decreased 2 basis points from 4.18% for the three months ended December 31, 2010 to 4.16% for the three months ended December 31, 2011.

Including the effect of the settlement deposit, the net interest margin for the three months ended December 31, 2011 decreased to 3.65% from 4.18% for the same period in 2010. This decrease was due to a lower mix of average loans for the three months ended December 31, 2011 as compared to the same quarter in 2010 (from 74% to 66%) as the average rate on earning assets for the three months ended December 31, 2011 decreased by 84 basis points from 5.11% to 4.27%. The net interest spread was 3.24% for the three months ended December 31, 2011 as compared to 3.83% for the same period in 2010, a decrease of 18 basis points. The benefit of noninterest sources funding earning assets increased from 35 basis points for the three months ended December 31, 2010 to 41 basis points for same period in 2011. The combination of a 59 basis point decline in the net interest spread and 6 basis points increase in the value of noninterest sources resulted in the 53 basis point decrease in the net interest margin.

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The Company believes it has effectively managed its net interest margin and net interest income over the past twelve months as market interest rates (on average) have declined. This factor has been significant to overall earnings performance over the past twelve months as net interest income (at 88%) represents the most significant component of the Company's revenues.

In order to fund significant growth in the average balance of loans of 26% over the twelve months ended December 31, 2011 as compared to 2010, the Company has relied primarily upon core deposit growth, together with use of increased levels of brokered and wholesale deposits. The major component of the growth in core deposits has been growth in money market accounts being promoted primarily through direct sales efforts by the business development staff and to growth in noninterest deposits primarily as a result of effectively building new and enhanced client relationships.

In terms of the average balance sheet composition or mix, loans, which generally have higher yields than securities and other earning assets, decreased from 80% of average earning assets in 2010 to 76% (80% excluding the effect of the settlement deposit) of average earning assets for 2011. This higher growth of average funding sources as compared to loans added average liquidity to the balance sheet in 2011. The decrease in average loans as a percentage of average earning assets in 2011 was due to the significant growth in average deposits as compared to 2010, including the settlement deposit which added \$118 million to average deposits. In 2011, average loans, excluding loans held for sale, increased \$396 million, a 26% increase, and average deposits increased by \$532 million, a 34% increase (\$414 million and 26% excluding the effect of the settlement deposit) as compared to the same period in 2010. Average time deposit growth in 2011 of \$73 million consisted primarily of brokered deposits, which were acquired in the first six months of 2011 from national firms at attractive term rates. The increase in average loans in 2011 as compared to 2010 is primarily attributable to growth in loans for both income producing commercial real estate and construction loans. Average investment securities for the year of 2011 amounted to 11% of average earning assets, a decrease of 3% from an average of 14% for the same period in 2010, as average liquidity was enhanced. The combination of federal funds sold and interest bearing deposits with other banks, averaged 10% of average earning assets for the year of 2011 as compared to 5% for the same period in 2010.

For the three months ended December 31, 2011, average loans were 66% of average earning assets (76% excluding the effect of the settlement deposit) as compared to 80% for the same period in 2010. Average loans increased \$433 million (27%) and average deposits increased \$943 million (55%) (\$546 million and 32% excluding the effect of the settlement deposit), during the three months ended December 31, 2011 as compared to the same quarter of 2010. The increase in average loans in the fourth quarter of 2011 as compared to the fourth quarter of 2010 is primarily attributable to growth in income producing commercial real estate and construction loans. Increases in average deposits in the fourth quarter of 2011, as compared to the fourth quarter of 2010, is attributable to growth in noninterest bearing demand deposits, and money market accounts. Average investment securities for the three months ended December 31, 2011 amounted to 10% of average earning assets, a decrease of 3% from an average of 13% for the same period in 2010. The combination of federal funds sold and interest bearing deposits with other banks, averaged 18% of average earning assets (6% excluding the effect of the settlement deposit) for the three months ended December 31, 2011 as compared to 5% for the same period in 2010, as average balance sheet liquidity was enhanced during the latest three month period.

The provision for credit losses was \$11.0 million for the year of 2011 as compared to \$9.3 million in 2010. The higher provisioning in 2011 as compared to 2010 is attributable to substantially higher amounts of loan growth in 2011 compared to 2010 (\$381 million as compared to \$276 million). For the twelve months ended December 31, 2011, net charge-offs totaled \$6.1 million (0.32% of average loans) compared to \$5.2 million (0.35% of average loans) for the twelve months ended December 31, 2010. Net charge-offs in the twelve months ended December 31, 2010 were primarily attributable to charge-offs of commercial real estate loans (\$151 thousand), commercial and industrial loans (\$3.4 million), construction loans

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(\$1.2 million), the unguaranteed portion of SBA loans (\$877 thousand), home equity loans (\$292 thousand), and mortgage and consumer loans (\$176 thousand).

For the three months ended December 31, 2011, the provision for credit losses was \$2.8 million as compared to \$3.6 million for the three months ended December 31, 2010. Net charge-offs of \$1.7 million in the fourth quarter of 2011 represented 0.34% of average loans, excluding loans held for sale, as compared to \$1.0 million or 0.26% of average loans, excluding loans held for sale, in the fourth quarter of 2010. Net charge-offs in the fourth quarter of 2011 were primarily attributable to charge-offs of construction loans (\$366 thousand), commercial and industrial loans (\$780 thousand), the unguaranteed portion of SBA loans (\$443 thousand) and consumer loans (\$83 thousand).

Total noninterest income for the year of 2011 was \$13.5 million compared to \$9.2 million in 2010, an increase of 46%. This increase was due primarily to a \$3.0 million increase in gains realized on the sale of residential loans and \$702 thousand of other income. Investment gains realized in both 2011 and 2010 were the result of asset/liability management decisions to either reduce call risk in the portfolio of U.S. Agency securities, to mitigate potential extension risk in longer-term mortgage-backed securities, to mitigate prepayment risk in mortgage-backed securities or to take advantage of a very strong fixed income market. Excluding investment securities gains, total noninterest income was \$12.1 million for the year of 2011 as compared to \$7.9 million for 2010, a 52% increase.

Total noninterest income for the three months ended December 31, 2011 increased to \$3.9 million from \$3.7 million for the three months ended December 31, 2010, a 5% increase. This increase was due primarily to an increase of \$320 thousand in gains on sales of residential mortgage loans in the fourth quarter of 2011, as compared to the fourth quarter of 2010, an increase of \$249 thousand in service charges on deposit accounts and an increase of \$101 thousand in other income, primarily associated with loan fee income offset by a decline of \$497 thousand of investment gains in the fourth quarter of 2010. There were no investment securities gains in the fourth quarter of 2011 as compared to investment securities gains of \$497 thousand in the fourth quarter of 2010. Excluding such investment securities gains, total noninterest income was \$3.9 million for the fourth quarter of 2011 as compared to \$3.2 million for the fourth quarter of 2010, an increase of 22%.

The efficiency ratio, which measures the ratio of noninterest expense to total revenue, was 56.22% for the full year of 2011 as compared to 59.26% for the same period in 2010. Cost control remains a key operating objective of the Company. Total noninterest expenses were \$63.3 million for the twelve months of 2011, as compared to \$51.0 million for 2010, a 24% increase. This increase includes \$1.7 million from a combination of non-recurring merger related expenses, system enhancements from a bank wide conversion in April 2011, and special events marketing. Cost increases for salaries and benefits were \$9.0 million primarily due to merit and benefit cost increases, increases in incentive pay, and staffing increases primarily as a result of expansion of the commercial lending and Residential Lending divisions and new branches. Legal, accounting, and professional fees increases of \$987 thousand were due substantially to resolution of problem loans and related collection costs. Premises and equipment expenses were \$89 thousand lower due primarily to benefits from the consolidation of two branches offsetting the cost of three new offices and other normal costs increases during 2011. Marketing and advertising costs increased by \$568 thousand due primarily to higher advertising and promotional expenses related to Residential Lending and special event marketing. Data processing costs increased by \$925 thousand due to system enhancements, noted above, expanded customer base, and the addition of three new branch offices. FDIC insurance premiums on the higher levels of deposits were \$497 thousand lower for the twelve months in 2011 as compared to 2010 due to a lower FDIC premium rate which took effect on April 1, 2011. Other expenses increases for the twelve months of 2011 versus 2010 amounted to \$1.4 million associated primarily with merger expenses of \$733 thousand and \$554 thousand of conversion expenses.

Total noninterest expenses were \$18.3 million for the three months ended December 31, 2011, as compared to \$13.5 million for the three months ended December 31, 2010, a 36% increase. Cost increases

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for salaries and benefits were \$2.9 million primarily due to merit and benefit cost increases, increases in incentive pay, and staffing increases primarily as a result of expansion of the commercial lending and residential lending divisions and new branches. Premises and equipment expenses were \$654 thousand higher due primarily to the cost of three new offices and normal increases in lease costs, offset by the benefits of branch consolidations during 2010. Marketing and advertising costs increased by \$272 thousand due primarily to higher levels of companywide media advertising and higher Residential Lending division marketing in 2011. Data processing costs increased by \$403 thousand due to system enhancements and the addition of three new branch offices. FDIC insurance premiums were \$98 thousand less due to lower FDIC premiums rates which took effect on April 1, 2011. Other expenses increased by \$438 thousand for the quarter ended December 31, 2011 compared to the same period in 2010, primarily due to \$400 thousand of merger related expenses. The efficiency ratio was 56.97% for the fourth quarter of 2011, as compared to 53.98% for the fourth quarter of 2010. Excluding the impact of merger related expenses, the efficiency ratio was 55.57% for the fourth quarter of 2011.

The ratio of common equity to total assets decreased from 8.72% at December 31, 2010 to 7.42% at December 31, 2011 due to an increase in balance sheet leverage. As discussed below, the regulatory capital ratios of the Bank and Company remain above well capitalized levels.

**Net Interest Income and Net Interest Margin**

Net interest income is the difference between interest income on earning assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans, loans held for sale, investment securities, and interest bearing deposits with banks. The cost of funds comprises interest expense on deposits, customer repurchase agreements and other borrowings, which are federal funds purchased and advances from FHLB. Noninterest bearing deposits and capital are other components representing funding sources. Changes in the volume and mix of assets and funding sources, along with the changes in yields earned and rates paid, determine changes in net interest income. Net interest income in 2011 was \$99.0 million compared to \$76.8 million in 2010 and \$59.5 million in 2009. For the three months ended December 31, 2011, net interest income was \$28.3 million as compared to \$21.3 million and \$16.7 million for the same periods in 2010 and 2009, respectively.

The tables below labeled "Average Balances, Interest Yields and Rates and Net Interest Margin" present the average balances and rates of the various categories of the Company's assets and liabilities for the years and three months ended December 31, 2011, 2010 and 2009. Included in the tables are measurements of interest rate spread and margin. Interest spread is the difference (expressed as a percentage) between the interest rate earned on earning assets less the interest expense on interest bearing liabilities. While net interest spread provides a quick comparison of earnings rates versus cost of funds, management believes that net interest margin provides a better measurement of performance. Margin includes the effect of noninterest bearing sources in its calculation and is net interest income expressed as a percentage of average earning assets.

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**Average Balances, Interest Yields and Rates, and Net Interest Margin**

(dollars in thousands)	Year Ended December 31,								
	2011			2010			2009		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
<b>ASSETS</b>									
Interest earning assets:									
Interest bearing deposits with other banks and other short-term investments									
	\$ 206,894	\$ 513	0.25%	\$ 8,151	\$ 108	1.32%	\$ 3,928	\$ 94	2.39%
Loans held for sale	63,198	2,458	3.89%	32,362	1,384	4.28%	3,999	198	4.95%
Loans(1)(2)	1,895,268	109,862	5.80%	1,498,942	88,000	5.87%	1,308,538	76,806	5.87%
Investment securities available for sale(2)									
	266,758	6,181	2.32%	259,576	6,992	2.69%	182,073	7,138	3.92%
Federal funds sold	50,507	110	0.22%	78,120	174	0.22%	46,412	102	0.22%
Total interest earning assets	2,482,625	119,124	4.80%	1,877,151	96,658	5.15%	1,544,950	84,338	5.46%
Noninterest earning assets									
	67,882			80,787			70,012		
Less: allowance for credit losses									
	26,915			21,747			19,344		
Total noninterest earning assets	40,967			59,040			50,668		
Total Assets	\$ 2,523,592			\$ 1,936,191			\$ 1,595,618		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>									
Interest bearing liabilities:									
Interest bearing transaction									
	\$ 64,849	\$ 236	0.36%	\$ 54,889	\$ 209	0.38%	\$ 52,083	\$ 161	0.31%
Savings and money market									
	869,971	8,488	0.98%	684,858	7,847	1.15%	401,912	6,144	1.53%
Time deposits									
	579,346	8,524	1.47%	506,570	8,830	1.74%	566,686	14,651	2.59%
Total interest bearing deposits	1,514,166	17,248	1.14%	1,246,317	16,886	1.35%	1,020,681	20,956	2.05%
Customer repurchase agreements and federal funds purchased									
	116,367	685	0.59%	96,862	731	0.75%	93,363	957	1.03%
Other short-term borrowings									
	22			3,737	27	0.72%	30,562	611	1.97%
Long-term borrowings									
	49,300	2,144	4.35%	49,300	2,188	4.44%	45,322	2,285	5.04%
Total interest bearing liabilities	1,679,855	20,077	1.20%	1,396,216	19,832	1.42%	1,189,928	24,809	2.09%
Noninterest bearing liabilities:									
Noninterest bearing demand									
	599,351			335,029			236,340		
Other liabilities									
	9,044			6,648			8,702		
Total noninterest bearing liabilities	608,395			341,677			245,042		
Stockholders' equity	235,342			198,298			160,648		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 2,523,592			\$ 1,936,191			\$ 1,595,618		
Net interest income		\$ 99,047			\$ 76,826			\$ 59,529	
Net interest spread			3.60%			3.73%			3.37%
Net interest margin			3.99%			4.09%			3.85%

- (1) Loans placed on nonaccrual status are included in average balances. Net loan fees and late charges included in interest income on loans totaled \$4.3 million, \$2.6 million, and \$2.1 million for the year ended December 31, 2011, 2010, and 2009 respectively.
- (2) Interest and fees on loans and investments exclude tax equivalent adjustments.

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**Average Balances, Interest Yields and Rates, and Net Interest Margin**

(dollars in thousands)	Three Months Ended December 31,								
	2011			2010			2009		
	Average Balance	Average Interest	Average Yield/Rate	Average Balance	Average Interest	Average Yield/Rate	Average Balance	Average Interest	Average Yield/Rate
<b>ASSETS</b>									
Interest earning assets:									
Interest bearing deposits with other banks and other short-term investments									
	\$ 539,924	\$ 341	0.25%	\$ 9,419	\$ 25	1.05%	\$ 7,470	\$ 39	2.07%
Loans held for sale	177,116	1,724	3.89%	74,210	769	4.14%	1,652	22	5.33%
Loans(1)(2)	2,030,986	29,583	5.78%	1,598,362	23,620	5.86%	1,350,424	20,554	6.04%
Investment securities available for sale(2)	301,517	1,427	1.88%	256,520	1,580	2.44%	224,225	1,747	3.09%
Federal funds sold	22,360	16	0.28%	82,981	46	0.22%	93,802	51	0.22%
Total interest earning assets	3,071,903	33,091	4.27%	2,021,492	26,040	5.11%	1,677,573	22,413	5.30%
Noninterest earning assets	68,745			80,973			74,569		
Less: allowance for credit losses	28,696			23,073			19,974		
Total noninterest earning assets	40,049			57,900			54,595		
Total Assets	\$ 3,111,952			\$ 2,079,392			\$ 1,732,168		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>									
Interest bearing liabilities:									
Interest bearing transaction	\$ 73,577	\$ 73	0.39%	\$ 59,616	\$ 69	0.46%	\$ 55,434	\$ 44	0.31%
Savings and money market	1,031,079	2,085	0.80%	732,839	1,889	1.02%	527,300	1,845	1.39%
Time deposits	570,624	1,969	1.37%	521,680	2,068	1.57%	524,860	2,975	2.25%
Total interest bearing deposits	1,675,280	4,127	0.98%	1,314,135	4,026	1.22%	1,107,594	4,864	1.74%
Customer repurchase agreements and federal funds purchased	134,332	152	0.45%	105,650	186	0.70%	82,106	184	0.89%
Other short-term borrowings							23,696	184	3.08%
Long-term borrowings	49,300	541	4.29%	49,300	541	4.35%	35,604	453	5.05%
Total interest bearing liabilities	1,858,912	4,820	1.03%	1,469,085	4,753	1.28%	1,249,000	5,685	1.81%
Noninterest bearing liabilities:									
Noninterest bearing demand	977,427			395,953			273,711		
Other liabilities	10,780			8,163			7,453		
Total noninterest bearing liabilities	988,207			404,116			281,164		
Stockholders' equity	264,833			206,191			202,004		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 3,111,952			\$ 2,079,392			\$ 1,732,168		
Net interest income		\$ 28,271			\$ 21,287			\$ 16,728	
Net interest spread			3.24%			3.83%			3.49%
Net interest margin			3.65%			4.18%			3.96%

- (1) Loans placed on nonaccrual status are included in average balances. Net loan fees and late charges included in interest income on loans totaled \$1.2 million, \$712 thousand, and \$752 thousand for the three months ended December 31, 2011, 2010, and 2009 respectively.
- (2) Interest and fees on loans and investments exclude tax equivalent adjustments.

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The rate/volume table below presents the composition of the change in net interest income for the periods indicated, as allocated between the change in net interest income due to changes in the volume of average earning assets and interest bearing liabilities, and the changes in net interest income due to changes in interest rates. As the table shows, the increase in net interest income in 2011 as compared to 2010 was a function of an increase in the volume of earning assets, and lower funding costs offsetting the decrease in interest income on earning assets, as compared to 2010. For 2010 over 2009, the change is due to an increase in the volume of earning assets, and an improving net interest margin resulting from lower funding costs more than offsetting the decrease in interest income on earning assets as compared to 2009.

**Rate/Volume Analysis of Net Interest Income**

(dollars in thousands)	2011 compared with 2010			2010 compared with 2009		
	Change Due to Volume	Change Due to Rate	Total Increase (Decrease)	Change Due to Volume	Change Due to Rate	Total Increase (Decrease)
<b>Interest earned on</b>						
Loans	\$ 23,268	\$ (1,406)	\$ 21,862	\$ 11,176	\$ 18	\$ 11,194
Loans held for sale	1,319	(245)	1,074	1,404	(218)	1,186
Investment securities	193	(1,004)	(811)	3,038	(3,184)	(146)
Interest bearing bank deposits	2,633	(2,228)	405	101	(87)	14
Federal funds sold	(62)	(2)	(64)	70	2	72
<b>Total interest income</b>	<b>27,351</b>	<b>(4,885)</b>	<b>22,466</b>	<b>15,789</b>	<b>(3,469)</b>	<b>12,320</b>
<b>Interest paid on</b>						
Interest bearing transaction	38	(11)	27	9	39	48
Savings and money market	2,121	(1,480)	641	4,325	(2,622)	1,703
Time deposits	1,269	(1,575)	(306)	(1,554)	(4,267)	(5,821)
Customer repurchase agreements	147	(193)	(46)	36	(262)	(226)
Other borrowings	(27)	(44)	(71)	(336)	(345)	(681)
<b>Total interest expense</b>	<b>3,548</b>	<b>(3,303)</b>	<b>245</b>	<b>2,480</b>	<b>(7,457)</b>	<b>(4,977)</b>
<b>Net interest income</b>	<b>\$ 23,803</b>	<b>\$ (1,582)</b>	<b>\$ 22,221</b>	<b>\$ 13,309</b>	<b>\$ 3,988</b>	<b>\$ 17,297</b>

**Provision for Credit Losses**

The provision for credit losses represents the amount of expense charged to current earnings to fund the allowance for credit losses. The amount of the allowance for credit losses is based on many factors which reflect management's assessment of the risk in the loan portfolio. Those factors include economic conditions and trends, the value and adequacy of collateral, volume and mix of the portfolio, performance of the portfolio, and internal loan processes of the Company and Bank.

Management has developed a comprehensive analytical process to monitor the adequacy of the allowance for credit losses. This process and guidelines were developed utilizing among other factors, the guidance from federal banking regulatory agencies. The results of this process, in combination with conclusions of the Bank's outside loan review consultant, support management's assessment as to the adequacy of the allowance at the balance sheet date. Please refer to the discussion under the caption "Critical Accounting Policies" for an overview of the methodology management employs on a quarterly basis to assess the adequacy of the allowance and the provisions charged to expense. Also, refer to the table under "Allowance for Credit Losses" at page 53, which reflects the comparative charge-offs and recoveries.

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During the year of 2011, the allowance for credit losses increased \$4.9 million reflecting \$11.0 million in provision for credit losses and \$6.1 million in net charge-offs during the period. The provision for credit losses was \$11.0 million for 2011 compared to a provision for credit losses of \$9.3 million for the same period in 2010. For 2011, net charge-offs amounted to \$6.1 million as compared to \$5.2 million for 2010. The higher provisioning in 2011 as compared to 2010 is primarily attributable to substantially higher loan growth in the twelve months of 2011 compared to 2010 (\$381 million as compared to \$276 million).

The provision for credit losses was \$2.8 million for the three months ended December 31, 2011 as compared to \$3.6 million for the three months ended December 31, 2010. At December 31, 2011, the allowance for credit losses represented 1.44% of loans outstanding, as compared to 1.48% at December 31, 2010 and 1.41% at September 30, 2011. The lower provisioning in the fourth quarter of 2011, as compared to both the third quarter of 2011 and the fourth quarter of 2010 is due to lower amounts of loan growth in the fourth quarter of 2011. The lower growth rate of just 1% in the fourth quarter of 2011 was due substantially to higher loan pay downs, while the pace of loan originations remains solid. Net charge-offs of \$1.7 million in the fourth quarter of 2011 represented 0.34% of average loans, excluding loans held for sale, as compared to \$1.0 million or 0.26% of average loans, excluding loans held for sale, in the fourth quarter of 2010. Net charge-offs in the fourth quarter of 2011 were primarily attributable to charge-offs of construction loans (\$366 thousand), commercial and industrial loans (\$780 thousand), the unguaranteed portion of SBA loans (\$443 thousand) and consumer loans (\$83 thousand).

As part of its comprehensive loan review process, the Bank's Board of Directors and Loan Committee or Bank's Credit Review Committee carefully evaluate loans which are past due 30 days or more. The Committees make a thorough assessment of the conditions and circumstances surrounding each delinquent loan. The Bank's loan policy requires that loans be placed on nonaccrual if they are ninety days past due, unless they are well secured and in the process of collection. Additionally, Credit Administration specifically analyzes the status of development and construction projects, sales activities and utilization of interest reserves in order to carefully and prudently assess the potential for increased levels of risk requiring additional reserves.

The maintenance of a high quality loan portfolio, with an adequate allowance for possible credit losses, will continue to be a primary management objective for the Company.

**Noninterest Income**

Total noninterest income includes service charges on deposits, gain on sale of loans, gain on sale of investments, income from bank owned life insurance ("BOLI") and other income.

Total noninterest income for the year of 2011 was \$13.5 million compared to \$9.2 million in 2010, an increase of 46%. This increase was due primarily to a \$3.0 million increase in gains on the sale of residential loans due substantially to higher levels of residential lending activity, a \$261 thousand increase in gains realized on the sale of SBA loans and a \$115 thousand increase in gains realized on the sale of investments. Other noninterest income increased by \$702 thousand primarily due to higher levels of other loan fee income and increased ATM fees. Excluding investment securities gains, total noninterest income was \$12.1 million for the twelve months of 2011 as compared to \$7.9 million for 2010, a 52% increase.

Total noninterest income for the three months ended December 31, 2011 increased to \$3.9 million from \$3.7 million for the three months ended December 31, 2010, a 5% increase. This increase was due primarily to an increase of \$320 thousand in gains on sales of residential mortgage loans in the fourth quarter of 2011, as compared to the fourth quarter of 2010, an increase of \$249 thousand in service charges on deposit accounts and an increase of \$101 thousand in other income, primarily associated with loan fee income offset by a decline of \$497 thousand of investment gains in the fourth quarter of 2010. There were no investment securities gains in the fourth quarter of 2011 as compared to investment securities gains of \$497 thousand in the fourth quarter of 2010. Excluding such investment securities gains, total noninterest

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income was \$3.9 million for the fourth quarter of 2011 as compared to \$3.2 million for the fourth quarter of 2010, an increase of 22%.

For the year ended December 31, 2011, service charges on deposit accounts increased to \$3.3 million from \$3.1 million, an increase of 8% over 2010. The increase in service charges was primarily related to fee increases due in part to the impact of lower interest rates on customer earnings credits and to new relationships. For the three months ended December 31, 2011, service charges on deposit accounts increased \$249 thousand to \$1.0 million compared to the same period in 2010, an increase of 32%. This increase was due to growth in new relationships.

Gain on sale of loans consists of SBA and residential mortgage loans. For the year ended December 31, 2011, gain on sale of loans increased from \$2.8 million to \$6.1 million compared to the same period in 2010 or 114%. For the three months ended December 31, 2011, gain on sale of loans increased from \$1.8 million to \$2.2 million compared to the same period in 2010. The higher amount of gains is due substantially to gains realized on the sale of residential mortgage loans.

The Company originates residential mortgage loans on a pre-sold basis, servicing released. Sales of these mortgage loans yielded gains of \$5.5 million for the year of 2011 compared to \$2.5 million in the same period in 2010. For the three months ended December 31, 2011, gains on the sale of residential mortgage loans were \$2.1 million as compared to \$1.8 million for the same three months of 2010. Loans sold are subject to repurchase in circumstances where documentation is deficient or the underlying loan becomes delinquent within a specified period following sale and loan funding. The Bank considers these potential recourse provisions to be a minimal risk, but has established a reserve under generally accepted accounting principles for possible repurchases. There has been no repurchases to date due to fraud or payment defaults. The reserve amounted to \$194 thousand at December 31, 2011 and is included in Other liabilities on the Consolidated Balance Sheet. The Bank does not originate "sub-prime" loans and has no exposure to this market segment. Operating the expanded Residential Lending origination for a full twelve months in 2011 compared to only six months of expanded operations in 2010, and higher refinancing activity resulting from a decline in residential mortgage rates in 2011 as compared to 2010, were the primary reasons for the increase in income.

The Company is an originator of SBA loans and its current practice is to sell the insured portion of those loans at a premium. Income from this source was \$574 thousand for the year ended December 31, 2011 compared to \$313 thousand for the year ended December 31, 2010. For the three months ended December 31, 2011, gains on the sale of SBA loans amounted to \$126 thousand as compared to \$4 thousand for the same period in 2010. Activity in SBA loan sales to secondary markets can vary widely from quarter to quarter.

Other income totaled \$2.3 million for the year ended 2011 as compared to \$1.6 million for the same period in 2010, an increase of 44%. The major components of income in this category consist of ATM fees, SBA service fees, noninterest loan fees and other noninterest fee income. ATM fees increased from \$559 thousand for the year ended 2010 to \$751 thousand for the year ended 2011, a 26% increase. SBA service fees were substantially unchanged at \$218 thousand for the year end 2011 as compared to \$217 thousand for the year ended 2010. Noninterest loan fees increased from \$634 thousand for the year ended 2010 to \$946 thousand for the same period in 2011, a 49% increase, primarily due to letter of credit fees and higher non-amortizable loan fees resulting from the higher loan growth during 2011. Other noninterest fee income was \$365 thousand for the year 2011 compared to \$167 thousand for the same period in 2010. Other income totaled \$562 thousand for the three months ended December 31, 2011 as compared to \$461 thousand for the same period in 2010, an increase of 22%.

Net investment gains amounted to \$1.4 million and \$0 for the year and quarter ended December 31, 2011, respectively, as compared to net investment gains of \$1.3 million and \$497 thousand for the year and quarter ended December 31, 2010, respectively. Investment gains realized in both 2011 and 2010 were the result of asset/liability management decisions to either reduce call risk in the portfolio of U.S. Agency

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securities, to mitigate potential extension risk in longer-term mortgage-backed securities or to mitigate prepayment risk in mortgage-backed securities.

**Noninterest Expense**

Total noninterest expense consists of salaries and employee benefits, premises and equipment expenses, marketing and advertising, data processing, legal, accounting and professional fees, FDIC insurance premiums and other expenses.

Total noninterest expenses were \$63.3 million for the twelve months of 2011, as compared to \$51.0 million for 2010, a 24% increase. This increase includes \$1.7 million from a combination of non-recurring merger related expenses, system enhancements from a bank wide conversion in April 2011, and special events marketing. For the three months ended December 31, 2011, total noninterest expenses were \$18.3 million, as compared to \$13.5 million for 2010, a 36% increase.

Salaries and employee benefits were \$34.5 million for the year ended 2011, as compared to \$25.6 million for 2010, a 35% increase. For the three months ended December 31, 2011, salaries and employee benefits amounted to \$10.2 million versus \$7.3 million for the same period in 2010, a 39% increase. These increases were due to staff additions (including substantial expansion of the commercial and Residential Lending divisions and the opening of three new offices in 2011), merit increases, increased incentive based compensation and increased benefit costs. At December 31, 2011, the Company's staff numbered 338, as compared to 292 at December 31, 2010 and 235 at December 31, 2009.

Premises and equipment expenses amounted to \$8.4 million for the year ended December 31, 2011 as compared to \$8.5 million for the same period in 2010, a 1% decrease. Premises and equipment expenses amounted to \$2.4 million for the three months ended December 31, 2011 as compared to \$1.7 million for the same period in 2010, a 38% increase. The decrease in expense for the year ended December 31, 2011 is due primarily to benefits from the consolidation of two offices closed in 2010 offset by the additional costs related to the opening of three new offices one opened in January, one opened in August, and one opened in November 2011. The increase in expense for the three months ended December 31, 2010 is due primarily to costs associated with the three offices opened in 2011. For the year and three months ended December 31, 2011, the Company recognized \$324 thousand and \$71 thousand respectively of sublease revenue as compared to \$410 thousand and \$93 thousand for the same period in 2010. The sublease revenue is a direct offset of premises and equipment expenses.

Marketing and advertising expenses increased from \$1.1 million for the year ended December 31, 2010 to \$1.6 million for 2011, an increase of 54%. Marketing and advertising expenses increased from \$139 thousand for the three months ended December 31, 2010 to \$411 thousand for the same period in 2011, a 196% increase. The primary reason for the increase in 2011 and three months ended December 31, 2011 was due to higher expenses related to Residential Lending and special events marketing.

Data processing expenses increased from \$2.6 million for the year ended December 31, 2010 to \$3.6 million for 2011, an increase of 35%. Data processing expenses increased from \$674 thousand for the three months ended December 31, 2010 to \$1.1 million in the same period in 2011, a 60% increase. The year and quarterly increases in expense were due to system enhancements beginning in April 2011, an expanded customer base, and the addition of three new branch offices.

Legal, accounting and professional fees were \$4.0 million for the year ended December 31, 2011, as compared to \$3.0 million for 2010, an increase of 33%. Legal, accounting and professional fees were \$1.1 million for the three months ended December 31, 2011, as compared to \$806 thousand in 2010, a 37% increase. The primary reason for the increase in the year and three months were due substantially to the resolution of problem loans and related collection costs, and legal fees from the terminated acquisition.

FDIC insurance premiums decreased to \$2.2 million for the year ended December 31, 2011 as compared to \$2.7 million for 2010, a decrease of 18%. For the three months ended December 31, 2011,

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FDIC insurance premiums amounted to \$567 thousand as compared to \$665 thousand for the same period in 2010, a 15% decrease. FDIC insurance premiums on the higher levels of deposits were lower for 2011 as compared to 2010 due to a lower FDIC premium rate, which took effect on April 1, 2011.

Other expenses increased to \$9.0 million for the year ended December 31, 2011 from \$7.7 million for the same period in 2010, an increase of 18%. For the three months ended December 31, 2011, other expenses amounted to \$2.6 million as compared to \$2.1 million for the same period in 2010, an increase of 21%. The major components of cost in this category include insurance expenses, broker fees, telephone, director fees, OREO expenses and other losses. The increase for the year of 2011 as compared to 2010 is primarily associated with merger expenses of \$733 thousand and \$554 thousand of conversion expenses. The increase for the quarter ended December 31, 2011 as compared to the same period in 2010 is primarily due to \$400 thousand of merger related expenses.

**Income Tax Expense**

The Company recorded income tax expense of \$13.7 million in 2011 compared to \$9.1 million in 2010 and \$6.0 million in 2009, resulting in an effective tax rate of 35.9%, 35.3% and 36.4%, respectively. The higher effective tax rate for 2011 relates to lower relative levels of tax preferred investments and loans, including associated tax credits, as compared to higher levels of income.

**BALANCE SHEET ANALYSIS**

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**Overview**

At December 31, 2011, the Company's total assets were \$2.83 billion, loans were \$2.06 billion, deposits were \$2.39 billion, borrowings which include customer repurchase agreements, were \$152.7 million and shareholders' equity was \$266.7 million. As compared to December 31, 2010, assets increased in 2011 by \$741.8 million or 35.5%, loans by \$380.8 million or 23%, deposits by \$665.3 million or 39%, borrowings, including customer repurchase agreements increased by \$5.8 million or 4% and shareholders' equity increased by \$62.0 million or 30%.

A substantial portion of the growth in 2011 in deposits is due to a focused sales effort to attract more core deposit customers, and an emphasis on requiring loan customers to maintain deposits with the Bank. The approximately \$618 million settlement deposit was in the balance sheet at September 30, 2011 but not at December 31, 2011. The dollar volume of time deposits increased slightly (5%) as of December 31, 2011 as compared to December 31, 2010, due to the addition of brokered time deposits in the first six months of 2011. However, time deposits as a percentage of total deposits declined in 2011, as new deposits were increasingly attracted to higher rate money market accounts along with growth in demand deposit accounts. Approximately 23% of the Bank's deposits at December 31, 2011 (\$555.1 million), and 31% at December 31, 2010 (\$527.7 million) were time deposits, which are generally the most expensive form of deposit because of their fixed rate and term.

The Company's shareholders' equity was enhanced in 2011 due to a net increase of \$34.1 million in preferred stock. On July 14, 2011, the Company issued 56,600 shares of the Company's Series B Preferred Stock, Series B, for a total purchase price of \$56.6 million pursuant to the SBLF program. Concurrent with the sale of Series B Preferred Stock, the Company redeemed, out of the proceeds of the issuance of the Series B Preferred Stock, all 23,325 outstanding shares of the Series A Preferred Stock related to the company's participation in the TARP CPP, for a redemption price of \$23.4 million, including accrued but unpaid dividends to the date of redemption.

**Investment Securities Available-for-Sale ("AFS") and Short-Term Investments**

The tables below and Note 3 to the Consolidated Financial Statements provide additional information regarding the Company's investment securities categorized as "available-for-sale" ("AFS"). The Company

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classifies all its investment securities as AFS. This classification requires that investment securities be recorded at their fair value with any difference between the fair value and amortized cost (the purchase price adjusted by any discount accretion or premium amortization) reported as a component of shareholders' equity (accumulated other comprehensive income), net of deferred income taxes. At December 31, 2011, the Company had a net unrealized gain in AFS securities of \$8.1 million as compared to a net unrealized gain in AFS securities of \$3.4 million at December 31, 2010. The deferred income tax liability at December 31, 2011 and 2010 related to these unrealized gains was \$3.3 million and \$1.4 million, respectively.

The AFS portfolio is comprised of U.S. Government agency securities (34% of AFS securities) with an average duration of 3.0 years, seasoned mortgage backed securities that are 100% agency issued (47% of AFS securities) which have an average expected life of 2.8 years with contractual maturities of the underlying mortgages of up to thirty years, municipal bonds (19% of AFS securities) which have an average duration of 7.1 years, and equity investments which comprise less than 1% of AFS securities. The equity investment includes common stock of three community banking companies which have an estimated fair value of \$299 thousand. Ninety nine percent (99%) of the investment securities which are debt instruments are rated AAA or AA. The remaining one percent (1%) of the investment securities which are debt instruments are municipal bonds which have a rating of A. All ratings represent investment grade issues.

At December 31, 2011, the investment portfolio amounted to \$313.8 million as compared to a balance of \$228.0 million at December 31, 2010, an increase of 38%. The increase in the portfolio coincided with an increase in core deposits. The investment portfolio is managed to achieve goals related to income, liquidity, interest rate risk management and to provide collateral for customer repurchase agreements and other borrowing relationships.

The following table provides information regarding the composition of the Company's investment securities portfolio at the dates indicated. As earlier noted, amounts are reported at estimated fair value. The change in composition of the portfolio at December 31, 2011 as compared to 2010 was due principally to Asset Liability Committee decisions to increase the mix of municipal bonds, which was believed to represent good value and principal security, and to increase holdings of structured mortgage backed securities issued by U.S. Government agencies or government sponsored enterprises which are believed to well position the Company in the current increasing interest rate environment.

(dollars in thousands)	2011		December 31, 2010		2009	
	Balance	Percent of Total	Balance	Percent of Total	Balance	Percent of Total
U. S. Government agency securities	\$ 103,753	33.1%	\$ 68,398	30.0%	\$ 76,107	32.4%
Residential mortgage backed securities	147,978	47.2%	109,909	48.2%	125,396	53.3%
Municipal bonds	61,773	19.6%	49,368	21.6%	33,325	14.2%
Other equity investments	307	0.1%	373	0.2%	399	0.1%
	\$ 313,811	100%	\$ 228,048	100%	\$ 235,227	100%

The growth in the investment portfolio in 2011 over 2010 was due in large part to investing a significant portion of the deposit growth in excess of loan growth that occurred in 2011.

The following table provides information, on an amortized cost basis, regarding the contractual maturity and weighted-average yield of the investment portfolio at December 31, 2011. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Yields on tax exempt securities have not been calculated on a tax equivalent basis.

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At December 31, 2011, there were no issuers, other than the U.S. Government and its agencies, whose securities owned by the Company had a book or fair value exceeding 10% of the Company's shareholders' equity.

(dollars in thousands)	One Year or Less		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
U. S. Government agency securities	\$ 15,783	1.50%	\$ 83,638	1.33%	\$ 2,862	2.98%			\$ 102,283	1.40%
Residential mortgage backed securities	8,526	2.17%	113,941	2.35%	17,559	3.32%	5,425	2.27%	145,451	2.45%
Municipal bonds			11,949	3.35%	45,599	3.64%			57,548	3.58%
Other equity investments									404	0.00%
	\$ 24,309		\$ 209,528	2.00%	\$ 66,020	3.53%	\$ 5,425	2.27%	\$ 305,686	2.31%

The Company also has a portfolio of short-term investments utilized for asset liability management needs which consist from time-to-time of discount notes, money market investments, and other bank certificates of deposit. This portfolio amounted to \$10.3 million at December 31, 2011 as compared to \$11.7 million at December 31, 2010.

Federal funds sold amounted to \$21.8 million at December 31, 2011 as compared to \$34.0 million at December 31, 2010. These funds represent excess daily liquidity which is invested on an unsecured basis with well capitalized banks, in amounts generally limited both in the aggregate and to any one bank.

Interest bearing deposits with banks and other short-term investments amounted to \$205.2 million at December 31, 2011 as compared to \$11.7 million at December 31, 2010. The significant increase in these overnight funds during 2011 represents excess daily liquidity held at the Federal Reserve to meet future loan fundings, to fund future increases in investment securities and to meet other general liquidity needs of the Company.

### **Loan Portfolio**

In its lending activities, the Company seeks to develop substantial relationships with clients whose businesses and individual banking needs will grow with the Bank. There has been a significant effort to grow the loan portfolio and to be responsive to the lending needs in the markets served, while maintaining sound asset quality.

Loan growth over the past year has been favorable, with loans outstanding reaching \$2.06 billion at December 31, 2011, an increase of \$380.1 million or 23% as compared to \$1.68 billion at December 31, 2010, and increased \$276.2 million or 20% as compared to \$1.40 billion at December 31, 2009.

The loan growth in 2011 was predominantly in the commercial, commercial real estate owner occupied, construction, residential, and investment commercial real estate segments. Traditional sources of credit for commercial real estate transactions have begun to come back into the market. Despite an increased level of competition for business, the Bank has been able to continue to grow its commercial real estate portfolio and attract new customers. Commercial real estate leasing in the Bank's market area has held up far better than in other parts of the country and values have generally held up well with upward price pressure in prime pockets. Meanwhile, multi-family properties in a number of sub-markets within the Bank's market area are experiencing normalized to declining vacancy rates, with upward pressure on rents. Construction lending picked up in 2011 on both the commercial and residential fronts. The housing market saw an uptick in demand, and tract development has returned in certain suburban markets. Commercial loan growth was strong in 2011 and was reflective of both expansion among existing customers and growth in new banking relationships. Consumer loan balances, including home equity lines of credit, saw modest

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growth last year. The mortgage rate environment, particularly in the 4<sup>th</sup> quarter, enticed many borrowers to refinance their home equity line or loan balances taking advantage of lower rates.

The Bank has a large portion of its loan portfolio related to real estate, with 72% consisting of commercial real estate, residential mortgage real estate and commercial and residential construction loans. Owner occupied commercial real estate and owner occupied commercial real estate construction represent 13.5% of the loan portfolio. When owner occupied commercial real estate is excluded, the percentage of total loans decreases to 58.5%. Real estate also serves as collateral for loans made for other purposes, resulting in 77% of loans being secured by real estate.

The following table shows the trends in the composition of the loan portfolio over the past five years.

(dollars in thousands)	Year Ended December 31,									
	2011		2010		2009		2008		2007	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	\$ 478,886	23%	\$ 411,744	26%	\$ 346,692	25%	\$ 334,999	27%	\$ 149,332	21%
Investment commercial real estate	756,645	37%	619,714	37%	499,501	36%	365,010	28%	265,678	37%
Owner occupied commercial real estate	250,174	12%	223,986	13%	196,433	14%	184,059	15%	127,079	18%
Real estate mortgage residential	39,552	2%	15,977	1%	9,236	1%	9,757	1%	2,160	
Construction commercial and residential(1)	429,669	21%	308,081	18%	252,695	18%	283,020	22%	110,115	15%
Home equity	97,103	5%	89,885	5%	87,283	6%	80,295	6%	57,515	8%
Other consumer	4,227		6,113		7,471		8,500	1%	4,798	1%
<b>Total loans</b>	<b>2,056,256</b>	<b>100%</b>	<b>1,675,500</b>	<b>100%</b>	<b>1,399,311</b>	<b>100%</b>	<b>1,265,640</b>	<b>100%</b>	<b>716,677</b>	<b>100%</b>
Less: Allowance for credit losses	(29,653)		(24,754)		(20,619)		(18,403)		(8,037)	
<b>Net loans</b>	<b>\$ 2,026,603</b>		<b>\$ 1,650,746</b>		<b>\$ 1,378,692</b>		<b>\$ 1,247,237</b>		<b>\$ 708,640</b>	

(1) Includes loans for land acquisition and development.

As noted above, a significant portion of the loan portfolio consists of commercial, construction and commercial real estate loans, primarily made in the Washington, D.C. metropolitan area and secured by real estate or other collateral in that market. Although these loans are made to a diversified pool of unrelated borrowers across numerous businesses, adverse developments in the Washington, D.C. metropolitan real estate market could have an adverse impact on this portfolio of loans and the Company's income and financial position. While our basic market area is the Washington, D.C. metropolitan area, in which 92% of our commercial real estate exposure exists, the Bank has made loans outside that market area where the nature and quality of such loans was consistent with the Bank's lending policies. At present, the Company believes that commercial real estate values are stable to improving in the specific sub-markets of the Washington, D.C. metropolitan market in which the Company has its most significant real estate exposure.

The federal banking regulators have issued guidance for those institutions which are deemed to have concentrations in commercial real estate lending. Pursuant to the supervisory criteria contained in the

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guidance for identifying institutions with a potential commercial real estate concentration risk, institutions which have (1) total reported loans for construction, land development, and other land which represent in total 100% or more of an institutions total risk-based capital; or (2) total commercial real estate loans representing 300% or more of the institutions total risk-based capital and the institution's commercial real estate loan portfolio has increased 50% or more during the prior 36 months are identified as having potential commercial real estate concentration risk. Institutions which are deemed to have concentrations in commercial real estate lending are expected to employ heightened levels of risk management with respect to their commercial real estate portfolios, and may be required to hold higher levels of capital. The Company, like many community banks, has a concentration in commercial real estate loans, and the Company has experienced significant growth in its commercial real estate portfolio in recent years. Commercial real estate loans and construction, land and land development loans represent 389% and 163%, respectively, of total risk based capital. Management has extensive experience in commercial real estate lending, and has implemented and continues to maintain heightened portfolio monitoring and reporting, and strong underwriting criteria with respect to its commercial real estate portfolio. The Company is well capitalized. Nevertheless, the Company could be required to maintain higher levels of capital as a result of our commercial real estate concentration, which could require us to obtain additional capital, and may adversely affect shareholder returns.

At December 31, 2011, the Company had no other concentrations of loans in any one industry exceeding 10% of its total loan portfolio. An industry for this purpose is defined as a group of businesses that are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

The Company has directly made higher risk loans that entail additional risks as compared to loans made following normal underwriting practices. These higher risk loan transactions, representing financing subordinated to loans made by the Bank or other parties, and occasionally referred to in this report as "subordinated financings" are currently made through the Company's subsidiary, ECV. This activity is limited as to individual transaction amount and total exposure amounts based on capital levels and is carefully monitored. Transactions are structured to provide ECV with returns commensurate to the risk through the requirement of additional interest following payoff of all loans, which additional interest is recorded as a component of non-interest income:

At December 31, 2011, ECV has \$2.3 million of loans outstanding for higher risk loan transaction relating to three real estate projects which are currently in a construction/sales phase. The loans are expected to be outstanding throughout 2012, with marketing and sales continuing until that time.

For the years ended December 31, 2011, 2010 and 2009, the Company recorded \$0, \$7 thousand and \$0 of noninterest income, respectively, from one subordinated financing transaction. The other two transactions were funded in the fourth quarter of 2011; as such \$0 noninterest income was recorded on these transactions.

Although the Company carefully underwrites each higher risk loan transaction and expects these transactions to provide additional revenues, there can be no assurance that any higher risk loan transaction, or the related loans made by the Bank, will prove profitable for the Company and Bank, that the Company will be able to receive any additional interest payments with respect to these loans, that any additional interest payments will be significant, or that the Company and Bank will not incur losses with respect to these transactions.

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The following table sets forth the time to contractual maturity of the loan portfolio as of December 31, 2011.

(dollars in thousands)	Total	Due In			
		One Year or Less	Over One to Five Years	Over Five to Ten Years	Over Ten Years
Commercial	\$ 478,886	\$ 240,164	\$ 181,232	\$ 54,898	\$ 2,592
Owner occupied commercial real estate	250,174	13,027	88,398	109,750	38,999
Investment commercial real estate	756,645	164,155	396,505	194,569	1,416
Real estate mortgage residential	39,552	9,410	20,489	4,284	5,369
Construction commercial and residential	429,669	197,154	187,453	42,940	2,122
Home equity	97,103	1,358	4,174	33,993	57,578
Other consumer	4,227	1,772	822	277	1,356
<b>Total loans</b>	<b>\$ 2,056,256</b>	<b>\$ 627,040</b>	<b>\$ 879,073</b>	<b>\$ 440,711</b>	<b>\$ 109,432</b>
<b>Loans with:</b>					
Predetermined fixed interest rate	\$ 810,903	\$ 122,599	\$ 507,074	\$ 151,499	\$ 29,731
Floating interest rate	1,245,353	504,441	371,999	289,212	79,701
<b>Total loans</b>	<b>\$ 2,056,256</b>	<b>\$ 627,040</b>	<b>\$ 879,073</b>	<b>\$ 440,711</b>	<b>\$ 109,432</b>

Loans are shown in the period based on final contractual maturity. Demand loans, having no contractual maturity and overdrafts, are reported as due in one year or less.

**Allowance for Credit Losses**

The provision for credit losses represents the amount of expense charged to current earnings to fund the allowance for credit losses. The amount of the allowance for credit losses is based on many factors which reflect management's assessment of the risk in the loan portfolio. Those factors include economic conditions and trends, the value and adequacy of collateral, volume and mix of the portfolio, performance of the portfolio, and internal loan processes of the Company and Bank.

Management has developed a comprehensive analytical process to monitor the adequacy of the allowance for credit losses. This process and guidelines were developed utilizing, among other factors, the guidance from federal banking regulatory agencies. The results of this process, in combination with conclusions of the Bank's outside loan review consultant, support management's assessment as to the adequacy of the allowance at December 31, 2011. During 2011, a provision for credit losses was made in the amount of \$11.0 million and net charge-offs amounted to \$6.1 million. A full discussion of the accounting for allowance for credit losses is contained in Note 1 to the Consolidated Financial Statements and activity in the allowance for credit losses is contained in Note 4 to the Consolidated Financial Statements. Also, please refer to the discussion under the caption, "Critical Accounting Policies" within Management's Discussion and Analysis of Financial Condition and Results of Operation for further discussion of the methodology which management employs to maintain an adequate allowance for credit losses, as well as the discussion under the caption "Provision for Credit Losses."

The allowance for credit losses represented 1.44% of total loans at December 31, 2011 as compared to 1.48% at December 31, 2010. At December 31, 2011, the allowance represented 90% of nonperforming loans as compared to 98% at December 31, 2010. The decrease in the coverage ratio was due substantially to the mix of the portfolio, loan growth, and the significant portion of well secured loans in the non performing category.

As part of its comprehensive loan review process, the Bank's Board of Directors, Directors' Loan Committee and Credit Review Committee carefully evaluate loans which are past due 30 days or more.

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The Committees make a thorough assessment of the conditions and circumstances surrounding each delinquent loan. The Bank's loan policy requires that loans be placed on nonaccrual if they are 90 days past due, unless they are well secured and in the process of collection. Additionally, Credit Administration specifically analyzes the status of development and construction projects, sales activities and utilization of interest reserves in order to carefully and prudently assess potential increased levels of risk which may require additional reserves.

At December 31, 2011, the Company had \$32.8 million of loans classified as nonperforming, and \$23.5 million of potential problem loans, as compared to \$25.3 million of nonperforming loans and \$36.5 million of potential problem loans at December 31, 2010. Please refer to Note 1 to the Consolidated Financial Statements under the caption "Loans" for a discussion of the Company's policy regarding impairment of loans. Please refer to "Nonperforming Assets" at page 56 for a discussion of problem and potential problem assets.

As the loan portfolio and allowance for credit losses review process continues to evolve, there may be changes to elements of the allowance and this may have an effect on the overall level of the allowance maintained. Historically, the Bank has enjoyed a high quality loan portfolio with relatively low levels of net charge-offs and low delinquency rates. In 2011, the Company witnessed a decreased level of net charge-offs and believes its level of net charge-offs and problem assets were below those of its peer banking companies. The maintenance of a high quality portfolio will continue to be a high priority for both management and the Board of Directors.

Management, being aware of the significant loan growth experienced by the Company, is intent on maintaining a strong credit review function and risk rating process. The Company has an experienced Credit Administration function, which provides independent analysis of credit requests and the management of problem credits. The Credit Department has developed and implemented analytical procedures for evaluating credit requests, has refined the Company's risk rating system, and has adopted enhanced monitoring of the loan portfolio (in particular the construction loan portfolio) and the adequacy of the allowance for credit losses, including stress test analyses. The loan portfolio analysis process is ongoing and proactive in order to maintain a portfolio of quality credits and to quickly identify any weaknesses before they become more severe.

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The following table sets forth activity in the allowance for credit losses for the past five years.

(dollars in thousands)	Year Ended December 31,				
	2011	2010	2009	2008	2007
Balance at beginning of year	\$ 24,754	\$ 20,619	\$ 18,403	\$ 8,037	\$ 7,373
Charge-offs:					
Commercial(1)	4,310	2,495	3,705	481	1,005
Investment commercial real estate(2)	277	719	488	29	
Owner occupied commercial real estate		246	239		
Real estate mortgage residential	95		553		
Construction commercial and residential(2)	1,366	1,698	177	497	
Home equity	295	43	427	124	
Other consumer	87	21	191	86	26
Total charge-offs	6,430	5,222	5,780	1,217	1,031
Recoveries:					
Commercial(1)	28	37	274	44	37
Investment commercial real estate(2)	126	3			
Owner occupied commercial real estate					
Real estate mortgage residential	3		2		
Construction commercial and residential(2)	183	7	2	50	
Home equity	3	2			
Other consumer	3		49		15
Total recoveries	346	49	327	94	52
Net charge-offs	6,084	5,173	5,453	1,123	979
Additions charged to operations	10,983	9,308	7,669	3,979	1,643
Acquired allowance Fidelity				7,510	
Balance at end of year	\$ 29,653	\$ 24,754	\$ 20,619	\$ 18,403	\$ 8,037
Ratio of allowance for credit losses to total loans outstanding at year end	1.44%	1.48%	1.47%	1.45%	1.12%
Ratio of net charge-offs during the year to average loans outstanding during the year	0.32%	0.34%	0.42%	0.12%	0.15%

(1) Includes SBA loans.

(2) Includes loans for land acquisition and development.

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The following table presents the allocation of the allowance for credit losses by loan category and the percent of loans each category bears to total loans. The allocation of the allowance at December 31, 2011 includes specific reserves of \$4.8 million against impaired loans of \$32.8 million as compared to specific reserves of \$3.9 million against impaired loans of \$25.3 million at December 31, 2010. The allocation of the allowance to each category is not necessarily indicative of future losses or charge-offs and does not restrict the usage of the allowance for any specific loan or category.

(dollars in thousands)	Year Ended December 31,									
	2011		2010		2009		2008		2007	
	Amount	%(1)	Amount	%(1)	Amount	%(1)	Amount	%(1)	Amount	%(1)
Commercial	\$ 9,609	23%	\$ 8,630	26%	\$ 9,871	25%	\$ 8,923	27%	\$ 3,300	21%
Investment commercial real estate(2)	7,304	37%	6,668	37%	3,328	36%	2,103	28%	1,447	37%
Owner occupied commercial real estate	1,898	12%	2,064	13%	3,167	14%	2,746	15%	1,606	18%
Real estate mortgage residential	399	2%	115	1%	28	1%	58	1%	21	
Construction commercial and residential(2)	8,546	21%	5,745	18%	3,680	18%	3,972	22%	1,314	15%
Home equity	1,528	5%	1,441	5%	382	6%	394	6%	233	8%
Other consumer	369		91		163		207	1%	116	1%
Unallocated										
<b>Total allowance for credit losses</b>	<b>\$ 29,653</b>	<b>100%</b>	<b>\$ 24,754</b>	<b>100%</b>	<b>\$ 20,619</b>	<b>100%</b>	<b>\$ 18,403</b>	<b>100%</b>	<b>\$ 8,037</b>	<b>100%</b>

(1) Represents the percent of loans in each category to total loans.

(2) Includes loans for land acquisition and development.

### **Nonperforming Assets**

As shown in the table below, the Company's level of nonperforming assets, which are comprised of loans delinquent 90 days or more, nonaccrual loans, restructured loans and other real estate owned ("OREO"), totaled \$36.0 million at December 31, 2011, representing 1.27% of total assets, as compared to \$32.0 million at December 31, 2010, representing 1.53%. The Company has been highly proactive in addressing existing and potential problem loans resulting from a weaker economy. Management remains attentive to early signs of deterioration in borrowers' financial conditions and to taking the appropriate action to mitigate risk. Furthermore, the Company is diligent in placing loans on nonaccrual status and believes, based on its loan portfolio risk analysis, that its allowance for loan losses at 1.44% of total loans at December 31, 2011 is adequate to absorb potential credit losses in the loan portfolio at that date.

Included in nonperforming assets at December 31, 2011 is OREO of \$3.2 million, consisting of eleven foreclosed properties. The Company had eleven OREO properties with a net carrying value of \$6.7 million at December 31, 2010. OREO properties are carried at the lower of cost or appraised value less estimated costs to sell. It is the Company's policy to obtain third party appraisals prior to foreclosure, and to obtain updated third party appraisals on OREO properties not less frequently than annually. Generally, the Company would obtain updated appraisals or evaluations where it has reason to believe, based upon market indications (such as comparable sales, legitimate offers below carrying value, broker indications and similar factors), that the current appraisal does not accurately reflect current value. During the year of 2011, the Company sold nine foreclosed properties with a net carrying value of \$6.3 million, recording a net loss on sale of \$444 thousand.

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Included in nonperforming assets are loans that we consider impaired. Impaired loans are defined as those which we believe it is probable that we will not collect all amounts due according to the contractual terms of the loan agreement, as well as that portion of loans whose terms have been modified in a troubled debt restructuring ("TDR") which have not shown a period of performance as required under applicable accounting standards. Valuation allowances for those loans determined to be impaired are evaluated in accordance with ASC Topic 310 "Receivables," and updated quarterly. For collateral dependent impaired loans, the carrying amount of the loan is determined by current appraised value less estimated costs to sell the underlying collateral, which may be adjusted downward under certain circumstances for actual events and/or changes in market conditions. For example, current average actual selling prices less average actual closing costs on an impaired multi-unit real estate project may indicate the need for an adjustment in the appraised valuation of the project, which in turn could increase the associated ASC Topic 310 specific reserve for the loan. Generally, all appraisals associated with impaired loans are updated on a not less than annual basis.

Loans are considered to have been modified in a TDR when due to a borrower's financial difficulties the Company makes unilateral concessions to the borrower that it would not otherwise consider. Concessions could include interest rate reductions, principal or interest forgiveness, forbearance, and other actions intended to minimize economic loss and to avoid foreclosure or repossession of collateral. Alternatively, management, from time-to-time and in the ordinary course of business, implements renewals, modifications, extensions, and/or changes in terms of loans to borrowers who have the ability to repay on reasonable market-based terms, as circumstances may warrant. Such modifications are not considered to be TDR's as the accommodation of a borrower's request does not rise to the level of a concession and/or the borrower is not experiencing financial difficulty. For example, (1) adverse weather conditions may create a short term cash flow issue for an otherwise profitable retail business which suggests a temporary interest only period on an amortizing loan; (2) there may be delays in absorption on a real estate project which reasonably suggests extension of the loan maturity at market terms; or (3) there may be maturing loans to borrowers with demonstrated repayment ability who are not in a position at the time of maturity to obtain alternate long-term financing. The most common change in terms provided by the Company is an extension of an interest only term. The determination of whether a restructured loan is a TDR requires consideration of all of the facts and circumstances surrounding the change in terms, and the exercise of prudent business judgment. The Company had six TDR's at December 31, 2011 totaling approximately \$13.9 million, as compared to two TDR's at December 31, 2010, totaling approximately \$4.4 million. These loans have demonstrated a period of at least six months of performance under the modified terms.

Total nonperforming loans amounted to \$32.8 million at December 31, 2011 (1.59% of total loans), compared to \$25.3 million at December 31, 2010 (1.51% of total loans). Nonperforming loans increased by \$7.5 million at December 31, 2011 as compared to 2010, and the ratio of nonperforming loans to total loans increased marginally primarily due to the migration of one large real estate secured loan (\$12 million) moving to nonperforming status.

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The following table shows the amounts and relevant ratios of nonperforming assets at December 31 for the past five years:

(dollars in thousands)	2011	2010	2009	2008	2007
<b>Nonaccrual Loans:</b>					
Commercial	\$ 5,718	\$ 5,137	\$ 4,364	\$ 3,506	\$ 1,174
Investment commercial real estate	7,662	3,913	1,641	3,960	641
Owner occupied commercial real estate	282		526	207	
Real estate mortgage residential	1,041	760	259		
Construction commercial and residential	17,459	14,645	15,192	17,588	3,386
Home equity	624	297	42	196	123
Other consumer	8	535			
<b>Accrual loans-past due 90 days:</b>					
Commercial					
Real estate commercial					
Other consumer					
<b>Total nonperforming loans(1)(2)</b>	<b>32,794</b>	<b>25,287</b>	<b>22,024</b>	<b>25,457</b>	<b>5,324</b>
Other real estate owned	3,225	6,701	5,106	909	
<b>Total nonperforming assets</b>	<b>\$ 36,019</b>	<b>\$ 31,988</b>	<b>\$ 27,130</b>	<b>\$ 26,366</b>	<b>\$ 5,324</b>
Coverage ratio, allowance for credit losses to total nonperforming loans	90.42%	97.89%	93.62%	72.29%	150.96%
Ratio of nonperforming loans to total loans	1.59%	1.51%	1.57%	2.01%	0.74%
Ratio of nonperforming assets to total assets	1.27%	1.53%	1.50%	1.76%	0.63%

- (1) As of December 31, 2011, nonaccrual loans reported in the table above included \$1.5 million related to loans that were restructured as "trouble debt restructurings" during 2011.
- (2) Gross interest income that would have been recorded in 2011 if nonaccrual loans shown above had been current and in accordance with their original terms was \$1.5 million, while interest actually recorded on such loans was \$350 thousand. See Note 1 to the Consolidated Financial Statements for a description of the Company's policy for placing loans on nonaccrual status.

Significant variation in the amount of nonperforming loans may occur from period to period because the amount of nonperforming loans depends largely on the condition of a relatively small number of individual credits and borrowers relative to the total loan portfolio.

At December 31, 2011, there were \$23.5 million of performing loans considered potential problem loans, defined as loans which are not included in the 90 day past due, nonaccrual or restructured categories, but for which known information about possible credit problems causes management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms which may in the future result in disclosure in the past due, nonaccrual or restructured loan categories. The \$23.5 million in potential problem loans at December 31, 2011, compared to \$25.7 million at September 30, 2011, and \$36.5 million at December 31, 2010. There were \$19.1 million of potential problem loans that comprised the \$36.5 million in loans considered as potential problem loans at December 31, 2010, that migrated to nonperforming loan status over the course of 2011. The nonperforming loan balance at December 31, 2011, included \$17.4 million the loans that were considered potential problem loans at December 31, 2010. The Company maintains a conservative posture with respect to its risk ratings, which allows for early intervention in potential problem loan situations. Based upon their status as potential problem loans, these loans receive heightened scrutiny and ongoing intensive risk management. Additionally, the Company's loan loss allowance methodology incorporates increased reserve factors for certain loans considered

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potential problem loans as compared to the general portfolio. See Allowance for Credit Losses on page 53 for a description of the allowance methodology.

**Other Earning Assets**

Residential mortgage loans held for sale amounted to \$176.8 million at December 31, 2011 compared to \$80.6 million at December 31, 2010. The significant increase in loans held for sale in 2011 was due to the Company's expansion of the Residential Lending origination and sales division throughout 2011. Origination and sale of these loans on a "servicing released" basis is emphasized by the Company in order to enhance noninterest income. Loans sold are subject to repurchase in circumstances where documentation is deficient or the underlying loan becomes delinquent within a specified period following sale and loan funding. There were no loan repurchases as a result of these defined events in 2011. While the Bank considers these potential recourse provisions to be a minimal risk, it has established a reserve based on the portfolio of loans subject to re-purchase. The Bank did not engage in the origination of subprime or "exotic" mortgage loans. See "Business" at page 1 for a description of the Bank's mortgage lending and brokerage activities.

Bank owned life insurance is utilized by the Company in accordance with income tax regulations as part of the Company's financing of its benefit programs. At December 31, 2011 this asset amounted to \$13.7 million as compared to \$13.3 million at December 31, 2010, which reflected an increase in cash surrender values, and not new investments.

**Intangible Assets**

The Company recognizes a servicing asset for the computed value of servicing fees on the sale of the guaranteed portion of SBA loans, which is in excess of a normal servicing fee. Assumptions related to loan term and amortization is made to arrive at the initial recorded value, which is included in intangible assets, net, on the Consolidated Balance Sheets.

For 2011, excess servicing fees of \$56 thousand were recorded, and \$30 thousand was amortized as a reduction of actual service fees collected, which is a component of other income. At December 31, 2011, the balance of excess servicing fees was \$179 thousand. For 2010, excess servicing fees of \$82 thousand were recorded, of which \$88 thousand was amortized as a reduction of actual service fees collected, which is a component of other income. At December 31, 2010, the balance of excess servicing fees was \$153 thousand.

In connection with the Fidelity acquisition and in connection with the purchase during 2011 of a branch office, the Company made an allocation of the purchase price to core deposit intangibles which were based off of an independent evaluation and are included in intangible assets, net, on the Consolidated Balance Sheets. The initial amount recorded for OBA was \$215 thousand which is being amortized over its remaining economic life of 1 year, in addition to the \$2.3 million recorded for Fidelity which is being amortized over its remaining economic life of 4.2 years as a component of other noninterest expense. The amounts amortized in 2011 and 2010 were \$284 thousand and \$185 thousand, respectively. The unamortized assets at December 31, 2011 and 2010 were \$1.8 million and \$1.9 million, respectively.

The Company recorded an initial amount of unidentified intangible (goodwill) incident to the acquisition of Fidelity and subsequent allowable adjustments through August 31, 2009, of \$2.2 million. The Company's testing of potential goodwill impairment (which is required annually), has resulted in no impairment being recorded.

**Deposits and Other Borrowings**

The principal sources of funds for the Bank are core deposits, consisting of demand deposits, NOW accounts, money market accounts, savings accounts and certificates of deposits from the local market areas

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surrounding the Bank's offices. The deposit base includes transaction accounts, time and savings accounts and accounts which customers use for cash management and which provide the Bank with a source of fee income and cross-marketing opportunities, as well as an attractive source of lower cost funds. To meet funding needs during periods of high loan demand and seasonal variations in core deposits, the Bank utilizes alternative funding sources such as secured borrowings from the FHLB; federal funds purchased lines of credit from correspondent banks and brokered deposits from a regional brokerage firm, a national brokered funds network and from the Promontory Interfinancial Network, LLC network.

For the year ended December 31, 2011, total deposits increased \$665.3 million, from \$1.73 billion to \$2.39 billion, or 39%, due largely to focused sales efforts in 2011 to attract more core deposit customers, to an emphasis on requiring loan customers to place deposits with the Bank, and to increases in wholesale funding.

Approximately 23% of the Bank's deposits at December 31, 2011 (\$555.1 million) were time deposits, which are generally the most expensive form of deposit because of their fixed rate and term, as compared to 31% at December 31, 2010 (\$527.7 million). This decrease in the percentage of total deposits provided by the time deposit category at December 31, 2011 as compared to December 31, 2010, was due to more emphasis on acquiring both core money market and demand deposit accounts.

For the twelve months ended December 31, 2011, noninterest bearing deposits increased \$288.2 million to \$688.5 million or a growth rate of 72% as compared to \$400.3 million as of December 31, 2010, while interest bearing deposits increased by \$377.1 million during the same period, a growth rate of 28%. Within interest bearing deposits, money market and savings accounts collectively amounted to \$1.07 billion at December 31, 2011 or 45% of total deposits, as compared to \$737.1 million, or 43% of total deposits, at December 31, 2010, a 45% increase.

The following table sets forth the maturities of time deposits with balances of \$100 thousand or more, which represent 14% and 20% of total deposits as of December 31, 2011 and 2010, respectively. See Note 7 to the Consolidated Financial Statements for additional information regarding the maturities of time deposits and the Average Balances Table at page 42 for the average rates paid on interest-bearing deposits. Time deposits of \$100 thousand or more can be more volatile and more expensive than time deposits of less than \$100 thousand. However, because the Bank focuses on relationship banking, and its marketplace demographics are favorable, its historical experience has been that large time deposits have not been more volatile or significantly more expensive than smaller denomination certificates.

(dollars in thousands)	December 31,		
	2011	2010	2009
Three months or less	\$ 109,615	\$ 112,706	\$ 89,318
More than three months through six months	90,094	78,567	74,189
More than six months through twelve months	44,764	108,181	74,152
Over twelve months	87,997	45,293	58,540
<b>Total</b>	<b>\$ 332,470</b>	<b>\$ 344,747</b>	<b>\$ 296,199</b>

From time to time, when appropriate in order to fund strong loan demand, the Bank accepts brokered time deposits, generally in denominations of less than \$100 thousand, from a regional brokerage firm, and other national brokerage networks, including the Promontory Interfinancial Network, LLC, for one-way purchased transactions. Additionally, the Bank participates in the Certificates of Deposit Account Registry Service ("CDARS"), which provides for reciprocal ("two-way") transactions among banks facilitated by the Promontory Interfinancial Network, LLC for the purpose of maximizing FDIC insurance. These reciprocal CDARS funds are classified as brokered deposits, although bank regulators have recognized that these deposits have many characteristics of core deposits. At December 31, 2011, total time deposits and savings and money market accounts, included \$311.2 million of brokered deposits, which represented

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13% of total deposits. The CDARS component represented \$100.0 million or 4% of total deposits. These sources are believed to represent a reliable and cost efficient alternative funding source for the Company. At December 31, 2010, total time deposits included \$151.6 million of brokered deposits, which represented 9% of total deposits. The CDARS component represented \$91.5 million, or 5% of total deposits. The higher level of wholesale funding during 2011 is attributable solely to longer-term deposits acquired in the first six months of 2011 in anticipation of higher levels of interest rates.

At December 31, 2011, the Company had approximately \$688.5 million in noninterest bearing demand deposits, representing 29% of total deposits. This compared to approximately \$400.3 million of these deposits at December 31, 2010 or 23% of total deposits. These deposits are primarily business checking accounts on which the payment of interest is prohibited by regulations of the Federal Reserve Board. As a result of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") banks are no longer prohibited from paying interest on demand deposits account, including those from businesses, effective in July 2011. To date, the elimination of this prohibition has had little impact on the Bank's interest expense, allocation of deposits, deposit pricing, loan pricing, net interest margin, ability to compete, ability to establish and maintain customer relationships, or profitability. The Bank routinely evaluates this provision and other portions of Dodd-Frank. Payment of interest on these deposits could have a significant negative impact on the Company's net interest income and net interest margin, net income, and the return on assets and equity, although no such effect is currently anticipated, as the payment of interest on accounts currently will not permit those business checking accounts above \$250,000 to receive deposit insurance, a factor deemed important. Unlimited deposit insurance on noninterest business accounts is currently set to expire at the end of 2012.

As an enhancement to the basic noninterest bearing demand deposit account, the Company offers a sweep account, or "customer repurchase agreement," allowing qualifying businesses to earn interest on short-term excess funds which are not suited for either a certificate of deposit or a money market account. The balances in these accounts were \$103.4 million at December 31, 2011 compared to \$97.6 million at December 31, 2010. Customer repurchase agreements are not deposits and are not insured by the FDIC, but are collateralized by U.S. government agency securities or U.S. government agency mortgage backed securities. These accounts are particularly suitable to businesses with significant fluctuation in the levels of cash flows. Attorney and title company escrow accounts are an example of accounts which can benefit from this product, as are customers who may require collateral for deposits in excess of FDIC insurance limits but do not qualify for other pledging arrangements. This program requires the Company to maintain sufficient investment securities for pledging purposes to accommodate the fluctuations in balances which may occur in these customer repurchase agreement accounts.

The Company had no outstanding balances under its federal funds lines of credit provided by correspondent banks at December 31, 2011 and 2010, respectively. At December 31, 2011 and 2010, the Bank had \$40 million of borrowings outstanding under its credit facility from the FHLB. Outstanding FHLB advances are secured by collateral consisting of a blanket lien on qualifying loans in the Bank's commercial mortgage and home equity loan portfolios.

In September 2011, the Company renewed its Loan Agreement and related Stock Security Agreement and Promissory Note (the "credit facility") with United Bank, pursuant to which the Company may borrow, on a revolving basis, up to \$30 million for working capital purposes, to finance capital contributions to the Bank and ECV.

Please refer to "Capital Resources and Adequacy" at page 68, and Note 8 to the Consolidated Financial Statements for additional information regarding the Company's short and long-term borrowings.

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The Company reported net income of \$16.7 million for the year ended December 31, 2010, a 60% increase from net income of \$10.4 million for the year ended December 31, 2009. Net income available to common shareholders, which is after accrual of preferred stock dividends, was \$15.4 million for year ended December 31, 2010, an 89% increase from net income available to common shareholders of \$8.1 million for the year ended December 31, 2009. The increase in net income for the twelve months ended December 31, 2010 can be attributed primarily to an increase in net interest income of 29% as compared to the same period in 2009. Net interest income growth was due substantially to growth in average earning assets of 22% in 2010 and to expansion of the net interest margin by 24 basis points to 4.09%.

Earnings per basic common share were \$0.78 for the year ended December 31, 2010, as compared to \$0.55 for 2009. Earnings per diluted common share were \$0.77 for the year ended December 31, 2010, as compared to \$0.55 for 2009. During 2009 there was a significant increase in the number of shares outstanding as a result of the Company's successful offering of common stock completed in September 2009, which in part accounts for the relatively lower level of income per share.

The Company had a return on average assets of 0.86% and a return on average common equity of 8.74% for the year of 2010, as compared to returns on average assets and average equity of 0.65% and 6.60%, respectively, for the year of 2009.

The Company's earnings are largely dependent on net interest income, which represented 89% of total revenue (defined as net interest income plus non interest income) in 2010 and 2009. For the twelve months ended December 31, 2010, the net interest margin, which measures the difference between interest income and interest expense (i.e. net interest income) as a percentage of earning assets increased from 3.85% for the twelve months ended December 31, 2009 to 4.09% for the twelve months ended December 31, 2010. The higher margin for 2010 as compared to 2009 was due to lower funding costs for both deposits and borrowings more than offsetting declines in earning asset yields. Higher average federal funds sold during the year ended December 31, 2010, as compared to the same period in 2009, contributed to the lower earning asset yields, as did lower yields on investment securities, due to lower market interest rates and the impact of investment sales. The benefit of noninterest sources funding earning assets declined by 12 basis points to 36 basis points for the twelve months ended December 31, 2010 as compared to 48 basis points for the same period in 2009, which effect was due to lower market interest rates in 2010 as compared to 2009. Additionally, while the average rate on earning assets for the twelve months ended December 31, 2010, as compared to the same period in 2009 decreased by 31 basis points from 5.46% to 5.15%, the cost of interest bearing liabilities decreased by 67 basis points from 2.09% to 1.42%, resulting in a net interest spread of 3.73% for the twelve months ended December 31, 2010, as compared to 3.37% for the same period in 2009, an increase of 36 basis points. The combination of a 36 basis point increase in the net interest spread and a 12 basis point decline in the value of noninterest sources resulted in the 24 basis point increase in the net interest margin in 2010 versus 2009.

Due to favorable core deposit growth during 2010, the need to meet loan funding objectives has not required the use of further alternative funding sources, such as FHLB advances, correspondent bank lines of credit and brokered time deposits, the balances of which declined since December 31, 2009. The major components of the growth in core deposits has been growth in a special money market account, and growth in noninterest deposits primarily as a result of effectively building new and enhanced client relationships.

In terms of the average balance sheet composition or mix, loans, which generally have higher yields than securities and other earning assets, decreased from 85% of average earning assets in 2009 to 82% of average earning assets in 2010. The decrease in average loans as a percentage of other earning assets is due to the growth in the securities portfolio and other earning assets resulting from higher levels of growth in deposits as compared to loans during 2010. In 2010, average loans, including loans held for sale, increased \$219 million, a 17% increase, and average deposits increased by \$324 million, a 26% increase as compared to 2009. The increase in average loans in 2010 as compared to 2009 is primarily attributable to growth in

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loans on income-producing commercial real estate and commercial loans. The increase in average deposits in 2010 as compared to 2009 is primarily attributable to noninterest bearing demand deposits and money market deposits. Investment securities for the year of 2010 amounted to 14% of average earning assets, an increase of 2% from an average of 12% for the year of 2009. Federal funds sold averaged 4% of average earning assets in 2010 as compared to 3% in 2009.

The provision for credit losses was \$9.3 million for the year of 2010 as compared to \$7.7 million in 2009. The higher provisioning in 2010 as compared to 2009 is attributable to substantially higher amounts of loan growth in 2010 compared to 2009. For the twelve months ended December 31, 2010, net charge-offs totaled \$5.2 million (0.35% of average loans) compared to \$5.5 million (0.42% of average loans) for the twelve months ended December 31, 2009. Net charge-offs in the twelve months ended December 31, 2010 were primarily attributable to charge-offs of commercial real estate loans owner occupied (\$246 thousand), commercial real estate loans (\$716 thousand), commercial and industrial loans (\$1.7 million), construction loans (\$1.7 million), and the unguaranteed portion of SBA loans (\$750 thousand).

At December 31, 2010, the allowance for credit losses represented 1.48% of loans outstanding, as compared to 1.47% at December 31, 2009. The allowance for credit losses was 98% of nonperforming loans at December 31, 2010, as compared to 94% at December 31, 2009.

Total noninterest income for the year of 2010 was \$9.2 million compared to \$7.3 million in 2009, an increase of 27%. This increase was due primarily to a \$1.8 million increase in gains realized on the sale of residential loans and \$234 thousand of other income. These increases were partially offset by a \$208 thousand decline in gains on the sale of investment securities and \$70 thousand decrease from the sale of SBA loans. Investment gains realized in both 2010 and 2009 were the result of asset/liability management decisions to either reduce call risk in the portfolio of U.S. Agency securities, to mitigate potential extension risk in longer-term mortgage-backed securities or to mitigate prepayment risk in mortgage-backed securities. Excluding investment securities gains, total noninterest income was \$7.9 million for the year of 2010 as compared to \$5.8 million for 2009, a 37% increase.

The efficiency ratio, which measures the ratio of noninterest expense to total revenue, was 59.26% for the full year of 2010 as compared to 64.01% for the same period in 2009, as the Company has enhanced its productivity. Cost control remains a key operating objective of the Company. Total noninterest expenses were \$51.0 million for the year of 2010, as compared to \$42.8 million for 2009, a 19% increase. The increase is primarily due to salaries, incentive compensation and benefits increases of \$4.6 million including staffing increases primarily as a result of expansion of the Residential Lending division, to premises and equipment expense increases of \$1.1 million and to other expense increases of \$2.1 million. Other expense increases include \$851 thousand due to the operating and disposition costs of OREO properties; legal, accounting and professional fees of \$256 thousand and data processing cost increases of \$273 thousand. Premises and equipment expenses include approximately \$827 thousand due to the acceleration of rent and leasehold improvement amortization for the consolidation of two branch offices in 2010. These higher costs were partially offset by a reduction in marketing and advertising costs of \$41 thousand and lower FDIC insurance costs of \$51 thousand, largely as a result of the absence of a special assessment of approximately \$723 thousand recorded in the second quarter of 2009.

During the year of 2010, the allowance for credit losses increased \$4.1 million reflecting \$9.3 million in provision for credit losses and \$5.2 million in net charge-offs during the period. The provision for credit losses was \$9.3 million for 2010 compared to a provision for credit losses of \$7.7 million for the same period in 2009. For 2010, net charge-offs amounted to \$5.2 million as compared to \$5.5 million for 2009. The higher provisioning in 2010 as compared to 2009 is attributable to increased amounts of loan growth in 2010 versus 2009, and to increased reserves for problem loans.

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The Company recorded income tax expense of \$9.1 million in 2010 compared to \$6.0 million in 2009, resulting in an effective tax rate of 35.3%, and 36.4%, respectively. The lower effective tax rate for 2010 relates to higher average tax exempt investments and loans, including associated tax credits.

At December 31, 2010, the Company's total assets were \$2.09 billion, loans were \$1.68 billion, deposits were \$1.73 billion, borrowings, including customer repurchase agreements, were \$146.9 million and shareholders' equity was \$204.7 million. As compared to December 31, 2009, assets increased in 2010 by \$283.9 million or 16%, loans by \$276.2 million or 20%, deposits by \$266.5 million or 18%, borrowings, including customer repurchase agreements decreased by \$3.2 million or 2% and shareholders' equity increased by \$16.4 million or 9%.

A substantial portion of the growth in 2010 in deposits is due to focused sales effort to attract more core deposit customers, and an emphasis on requiring loan customers to maintain deposits with the Bank. The dollar volume of time deposits has remained relatively unchanged at December 31, 2010 as compared to December 31, 2009; however, time deposits as a percentage of total deposits declined in 2010 as new deposits were increasingly attracted to higher rate money market accounts. Approximately 31% of the Bank's deposits at December 31, 2010 (\$527.7 million), and 35% at December 31, 2009 (\$509.7 million) were time deposits, which are generally the most expensive form of deposit because of their fixed rate and term.

At December 31, 2010, the investment portfolio amounted to \$228.0 million as compared to a balance of \$235.2 million at December 31, 2009, a decrease of 3%. The decrease in the portfolio coincided with an increase in loans held for sale beginning in the second quarter of 2010, which required higher levels of funding. The investment portfolio is managed to achieve goals related to income, liquidity, interest rate risk management and to provide collateral for customer repurchase agreements and other borrowing relationships.

Federal funds sold amounted to \$34.0 million at December 31, 2010 as compared to \$88.2 million at December 31, 2009. These funds represent excess daily liquidity which is invested on an unsecured basis with well capitalized banks, in amounts generally limited both in the aggregate and to any one bank.

Loan growth over the past year has been favorable, with loans outstanding reaching \$1.68 billion at December 31, 2010, an increase of \$276.2 million or 20% as compared to \$1.40 billion at December 31, 2009.

The Company had loan growth of \$276.2 million during 2010, with \$145.6 million, or 53% of loan growth for the year, being recorded in the fourth quarter of 2010. The loan growth was predominantly in the commercial, commercial real estate owner occupied, and investment commercial real estate segments.

The allowance for credit losses represented 1.48% of total loans at December 31, 2010 as compared to 1.47% at December 31, 2009. At December 31, 2010, the allowance represented 98% of nonperforming loans as compared to 94% at December 31, 2009. The increase in the coverage ratio was due substantially to loan growth during 2010, as new credits exhibit lower levels of potential credit risk.

The Company's level of nonperforming assets, which are comprised of loans delinquent 90 days or more, nonaccrual loans, restructured loans and OREO, totaled \$32.0 million, at December 31, 2010, representing 1.53% of total assets, as compared to \$27.1 million, at December 31, 2009, representing 1.50%. While the total amount of nonperforming assets at December 31, 2010 was higher than at December 31, 2009, the ratio of nonperforming loans to total loans was lower at December 31, 2010 as compared to December 31, 2009. The Company has been highly proactive in addressing existing and potential problem loans resulting from a weaker economy. Management remains attentive to early signs of deterioration in borrowers' financial conditions and to taking the appropriate action to mitigate risk. Furthermore, the Company is diligent in placing loans on nonaccrual status and believes, based on its loan portfolio risk analysis, that its allowance for loan losses at 1.48% of total loans at December 31, 2010 is adequate to absorb potential credit losses in the loan portfolio at that date.

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Included in nonperforming assets at December 31, 2010 is OREO of \$6.7 million, consisting of eleven foreclosed properties. The Company had twelve OREO properties with a net carrying value of \$5.1 million at December 31, 2009. OREO properties are carried at the lower of cost or appraised value less estimated costs to sell. It is the Company's policy to obtain third party appraisals prior to foreclosure, and to obtain updated third party appraisals on OREO properties not less frequently than annually. Generally, the Company would obtain updated appraisals or evaluations where it has reason to believe, based upon market indications (such as comparable sales, legitimate offers below carrying value, broker indications and similar factors), that the current appraisal does not accurately reflect current value. During the year of 2010, the Company sold eight foreclosed properties with a net carrying value of \$2.7 million, recording a net loss on sale of \$366 thousand.

Residential mortgage loans held for sale amounted to \$80.6 million at December 31, 2010 compared to \$1.6 million at December 31, 2009. The significant increase in loans held for sale in 2010 was due to the Company's expansion of the Residential Lending origination and sales division in the second quarter of 2010. Origination and sale of these loans on a "servicing released" basis is emphasized by the Company in order to enhance noninterest income. Loans sold are subject to repurchase in circumstances where documentation is deficient or the underlying loan becomes delinquent within a specified period following sale and loan funding. There were no loan repurchases as a result of these defined events in 2010. While the Bank considers these potential recourse provisions to be a minimal risk, it has established a reserve based on the portfolio of loans subject to re-purchase. The Bank did not engage in the origination of subprime or "exotic" mortgage loans.

Bank owned life insurance is utilized by the Company in accordance with income tax regulations as part of the Company's financing of its benefit programs. At December 31, 2010 this asset amounted to \$13.3 million as compared to \$12.9 million at December 31, 2009, which reflected an increase in cash surrender values, and not new investments.

For the twelve months ended December 31, 2010, noninterest bearing deposits increased \$92.3 million as compared to December 31, 2009 to \$400.3 million or a growth rate of 30%, while interest bearing deposits increased by \$174.2 million during the same period, a growth rate of 15%. Within interest bearing deposits, money market and savings accounts collectively amounted to \$737.1 million at December 31, 2010 or 43% of total deposits, as compared to \$582.9 million, or 40% of total deposits, at December 31, 2009, a 27% increase.

For the year ended December 31, 2010, total deposits increased \$266.5 million, from \$1.46 billion to \$1.73 billion, or 18%, due largely to focus sales efforts in 2010 to attract more core deposit customers, and also due to the emphasis on requiring loan customers to place deposits with the Bank.

At December 31, 2010, the Company had approximately \$400.3 million in noninterest bearing demand deposits, representing 23% of total deposits. This compared to approximately \$308 million of these deposits at December 31, 2009 or 21% of total deposits. These deposits are primarily business checking accounts.

The Company had no outstanding balances under its federal funds lines of credit provided by correspondent banks at December 31, 2010 and 2009, respectively. At December 31, 2010, the Bank had \$40 million of borrowings outstanding under its credit facility from the FHLB, as compared to \$50 million at December 31, 2009. Outstanding FHLB advances are secured by collateral consisting of a blanket lien on qualifying loans in the Bank's commercial mortgage and home equity loan portfolios.

Table of Contents**CONTRACTUAL OBLIGATIONS**

The Company has various financial obligations, including contractual obligations and commitments that may require future cash payments. Except for its loan commitments, as shown in Note 15 to the Consolidated Financial Statements Financial Instruments with Off-Balance Sheet Risk, the following table shows details on these fixed and determinable obligations as of December 31, 2011 in the time period indicated.

(dollars in thousands)	Within One Year	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated maturity(1)	\$ 1,836,981	\$	\$	\$	\$ 1,836,981
Time deposits(1)	334,040	208,049	13,025		555,114
Borrowed funds(2)	103,362	20,000	19,300	10,000	152,662
Operating lease obligations	5,350	10,460	9,330	11,207	36,347
Outside data processing(3)	2,246	3,775	2,052		8,073
Total	\$ 2,281,979	\$ 242,284	\$ 43,707	\$ 21,207	\$ 2,589,177

- (1) Excludes accrued interest payable at December 31, 2011.
- (2) Borrowed funds include customer repurchase agreements, and other short-term and long-term borrowings.
- (3) The Bank has outstanding obligations under its current core data processing contract that expires in April 2015 and one other vendor arrangement that relates to data communications and data software that expires in December 2012.

**OFF BALANCE SHEET ARRANGEMENTS**

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. See Note 15 to the Consolidated Financial Statements for a summary list of loan commitments at December 31, 2011 and 2010.

Loan commitments represent agreements to lend to a customer as long as there is no violation of any condition established in the contract and which have been accepted in writing by the borrower. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained is based on management's credit evaluation of the borrower. Collateral obtained varies, and may include certificates of deposit, accounts receivable, inventory, property and equipment, residential and commercial real estate.

Standby letters of credit are conditional commitments issued by the Company which guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above

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and is required in instances which the Company deems necessary. At December 31, 2011, approximately 85% of the dollar amount of standby letters of credit was collateralized.

With the exception of these off-balance sheet arrangements, the Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, capital expenditures or capital resources, that is material to investors.

**LIQUIDITY MANAGEMENT**

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Liquidity is a measure of the Company's and Bank's ability to meet loan demand and to satisfy depositor withdrawal requirements in an orderly manner. The Bank's primary sources of liquidity consist of cash and cash balances due from correspondent banks, excess reserves at the Federal Reserve, loan repayments, federal funds sold and other short-term investments, maturities and sales of investment securities, income from operations and new core deposits into the Bank. The Bank's investment portfolio of debt securities is held in an available-for-sale status which allows for flexibility, subject to holdings held as collateral for customer repurchase agreements, to generate cash from sales as needed to meet ongoing loan demand. These sources of liquidity are considered primary and are supplemented by the ability of the Company and Bank to borrow funds or issue brokered deposits, which are termed secondary sources and which are substantial. The Company's secondary sources of liquidity include a \$30 million line of credit with a regional bank, secured by a portion of the stock of the Bank, against which there were no amounts outstanding at December 31, 2011. Additionally, the Bank can purchase up to \$82.8 million in federal funds on an unsecured basis from its correspondents, against which there were no amounts outstanding at December 31, 2011 and can borrow unsecured funds under one-way CDARS brokered deposits in the amount of \$423.2 million, against which there was \$82.6 million outstanding at December 31, 2011. The Bank also has a commitment at December 31, 2011 from the Promontory Interfinancial Network to place up to \$100 million of brokered deposits from its Insured Network Deposit ("IND") program with the Bank, with an actual balance of \$34.0 million at December 31, 2011. At December 31, 2011, the Bank was also eligible to make advances from the FHLB up to \$249.4 million based on collateral at the FHLB, of which \$40.0 million was outstanding at December 31, 2011. Also, the Bank may enter into repurchase agreements as well as obtaining additional borrowing capabilities from the FHLB provided adequate collateral exists to secure these lending relationships. The Bank also has a back-up borrowing facility through the Discount Window at the Federal Reserve Bank of Richmond ("Federal Reserve Bank"). This facility, which amounts to approximately \$171.0 million, is collateralized with specific loan assets identified to the Federal Reserve Bank. It is anticipated, except for periodic testing, that this facility would be utilized for contingency funding only.

The loss of deposits, through disintermediation, is one of the greater risks to liquidity. Disintermediation occurs most commonly when rates rise and depositors withdraw deposits seeking higher rates in alternative savings and investment sources than the Bank may offer. The Bank was founded under a philosophy of relationship banking and, therefore, believes that it has less of an exposure to disintermediation and resultant liquidity concerns than do many banks. Furthermore, deposit interest rate offerings are routinely subjected to competitive rate surveys purchased from independent sources. Those weekly surveys show the Bank's deposit rates to be competitive to local bank. There is, however, a risk that some deposits would be lost if rates were to increase and the Bank elected not to remain competitive with its deposit rates. Under those conditions, the Bank believes that it is well positioned to use other sources of funds such as FHLB borrowings, brokered deposits, repurchase agreements and correspondent banks' lines of credit to offset a decline in deposits in the short run. Over the long-term, an adjustment in assets and change in business emphasis could compensate for a potential loss of deposits. The Bank also maintains a marketable investment portfolio to provide flexibility in the event of significant liquidity needs. The Asset Liability Committee of the Bank's Board of Directors has adopted policy guidelines which emphasize the importance of core deposits and adequate asset liquidity. In the year ended December 31,

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2011, the Bank was able to substantially increase its core deposits through both new relationships and increases to accounts of existing relationships.

At December 31, 2011, under the Bank's liquidity formula, it had \$1.20 billion of primary and secondary liquidity sources. The amount is deemed adequate to meet current and projected funding needs.

**CAPITAL RESOURCES AND ADEQUACY**

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The assessment of capital adequacy depends on a number of factors such as asset quality and mix, liquidity, earnings performance, changing competitive conditions and economic forces, regulatory measures and policy, as well as the overall level of growth and complexity of the balance sheet. The adequacy of the Company's current and future capital needs is monitored by management on an ongoing basis. Management seeks to maintain a capital structure that will assure an adequate level of capital to support anticipated asset growth and to absorb potential losses.

The federal banking regulators have issued guidance for those institutions which are deemed to have concentrations in commercial real estate lending. Pursuant to the supervisory criteria contained in the guidance for identifying institutions with a potential commercial real estate concentration risk, institutions which have (1) total reported loans for construction, land development, and other land acquisitions which represent in total 100% or more of an institution's total risk-based capital; or (2) total commercial real estate loans representing 300% or more of the institution's total risk-based capital and the institution's commercial real estate loan portfolio has increased 50% or more during the prior 36 months are identified as having potential commercial real estate concentration risk. Institutions which are deemed to have concentrations in commercial real estate lending are expected to employ heightened levels of risk management with respect to their commercial real estate portfolios, and may be required to hold higher levels of capital. The Company, like many community banks, has a concentration in commercial real estate loans, and the Company has experienced significant growth in its commercial real estate portfolio in recent years. At December 31, 2011, non-owner-occupied commercial real estate loans and construction, land and land development loans represent 389% and 163%, respectively of total risk based capital. Management has extensive experience in commercial real estate lending, and has implemented and continues to maintain heightened risk management procedures, and strong underwriting criteria with respect to its commercial real estate portfolio. Monitoring practices include periodic stress testing analysis to evaluate changes to cash flows, owing to interest rate increases and declines in net operating income. Nevertheless, we may be required to maintain higher levels of capital as a result of our commercial real estate concentration, which could require us to obtain additional capital, and may adversely affect shareholder returns.

The Company has a credit facility with United Bank, pursuant to which the Company may borrow, on a revolving basis, up to \$30 million for working capital purposes, to finance capital contributions to the Bank and ECV. The credit facility is secured by a first lien on a portion of the stock of the Bank, pursuant to which the Company may borrow, and bears interest at a floating rate equal to the Wall Street Journal Prime Rate minus 0.25% with a floor interest rate of 4.25%. Interest is payable on a monthly basis. The term of the credit facility expires on August 31, 2012. There were no amounts outstanding under this credit facility at December 31, 2011 or 2010.

On July 14, 2011, the Company entered into and consummated a Securities Purchase Agreement (the "Purchase Agreement") with the Secretary of the Treasury of the United States (the "Secretary") under the Small Business Lending Fund program. Pursuant to the Purchase Agreement, the Company issued 56,600 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock"), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$56,600,000.

The Series B Preferred Stock is entitled to receive non-cumulative dividends, beginning October 1, 2011. The dividend rate, as a percentage of the liquidation amount, can fluctuate on a quarterly basis

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during the first ten quarters during which the Series B Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" or "QSBL" (as defined in the Purchase Agreement) by the Bank. The dividend rate for the first two dividend periods was one percent (1%). For the third through ninth calendar quarters, the dividend rate may be adjusted to between one percent (1%) and five percent (5%) per annum, to reflect the amount of change if any, in the Bank's level of QSBL. If the level of the Bank's qualified small business loans declines so that the percentage increase in QSBL as compared to the baseline level is less than ten percent (10%), then the dividend rate payable on the Series B Preferred Stock would increase. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the increase in QSBL as compared to the baseline. After four and one half years from issuance, the dividend rate will increase to nine percent (9%).

The Series B Preferred Stock may be redeemed at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of its federal banking regulator.

On July 14, 2011, concurrent with the sale of the Series B Preferred Stock under the Small Business Lending Fund, the Company entered into and consummated a letter agreement with the Treasury, pursuant to which the Company redeemed, out of the proceeds of the issuance of the Series B Preferred Stock, all 23,325 outstanding shares of the Series A Preferred Stock related to the company's participation in the Troubled Asset Relief Program's Capital Purchase Program, for a redemption price of \$23,425,398, including accrued but unpaid dividends to the date of redemption.

On August 30, 2010, the Company entered into and consummated a Note Exchange Agreement, pursuant to which the Company issued, on a private placement basis, to eight parties, all of which are current or former directors of the Company or accounts for the benefit of such persons, an aggregate of \$9.3 million of a new series of subordinated notes (the "New Notes"), in exchange for an equal principal amount of the Company's 10% Subordinated Notes due September 30, 2014 (the "Old Notes"), which were issued in August 2008. The New Notes bear interest, payable on the first day of each month, at a fixed rate of 10.0% per year. The New Notes have a maturity of September 30, 2016. The New Notes are redeemable at the option of the Company, in whole or in part, on any interest payment date at the principal amount thereof, plus interest to the date of redemption. The New Notes are intended to qualify as Tier 2 capital for regulatory purposes to the fullest extent permitted. The payment of principal on the Notes may only be accelerated upon the occurrence of certain bankruptcy or receivership related events relating to the Company or, to the extent permitted under capital rules to be adopted by the Federal Reserve Board pursuant to Dodd-Frank, a major bank subsidiary of the Company.

The issuance of the New Notes in exchange for the Old Notes (the "Exchange") is intended to enable the Company to maximize the regulatory capital treatment of its indebtedness. As a result of the Exchange, 100% of the principal amount of the New Notes was eligible for inclusion in capital at December 31, 2010. The capital treatment of the New Notes is being phased out in the last five years they are outstanding commencing in October 2011, at a rate of 20% per year. Thus, at December 31, 2011, only 80% of the principal amount of the New Notes is eligible for inclusion in Tier 2 capital.

At December 31, 2011, the capital position of the Company and its wholly owned subsidiary, the Bank, continues to exceed regulatory requirements and guidelines. The primary indicators relied on by bank regulators in measuring the capital position are the Tier 1 risk-based capital ratio, Total risk-based capital ratio, and the Leverage ratio. Tier 1 capital consists of common and qualifying preferred shareholders' equity (including without limit the preferred stock issued to the Treasury) less goodwill and other intangibles. Total risk-based capital consists of Tier 1 capital, plus qualifying subordinated debt, and the qualifying portion of the allowance for credit losses, and for the Company to a limited extent, excess amounts of restricted core capital elements. Risk-based capital ratios are calculated with reference to

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risk-weighted assets, which are prescribed by regulation. The measure of Tier 1 capital to average assets for the prior quarter is often referred to as the Leverage ratio.

The Company's capital ratios were all well in excess of guidelines established by the Federal Reserve Board and the Bank's capital ratios were in excess of those required to be classified as a "well capitalized" institution under the prompt corrective action provisions of the Federal Deposit Insurance Act. The Company's and Bank's capital ratios at December 31, 2011 and 2010 are shown in Note 17 to the Consolidated Financial Statements.

The ability of the Company to continue to grow is dependent on its earnings and those of the Bank, the ability to obtain additional funds for contribution to the Bank's capital, through additional borrowings, through the sale of additional common stock or preferred stock, or through the issuance of additional qualifying equity equivalents, such as subordinated debt or trust preferred securities. The capital levels required to be maintained by the Company and Bank may be impacted as a result of the Bank's concentrations in commercial real estate loans. See "Regulation" at page 9 and "Risk Factors" at page 17.

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**IMPACT OF INFLATION AND CHANGING PRICES**

The Consolidated Financial Statements and Notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of operations. Unlike most industrial companies, nearly all of our assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods or services.

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**NEW AUTHORITATIVE ACCOUNTING GUIDANCE**

Refer to Note 1 to the Consolidated Financial Statements for New Authoritative Accounting Guidance and their expected impact on the Company's Financial Statements.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Asset/Liability Management of Interest Rate Risk**

A fundamental risk in banking is exposure to market risk, or interest rate risk, since a bank's net income is largely dependent on net interest income. The Asset Liability Committee ("ALCO") of the Bank's Board of Directors formulates and monitors the management of interest rate risk through policies and guidelines established by it and the full Board of Directors and through review of detailed reports discussed quarterly. In its consideration of risk limits, the ALCO considers the impact on earnings and capital, the level and direction of interest rates, liquidity, local economic conditions, outside threats and other factors. Banking is generally a business of managing the maturity and re-pricing mismatch inherent in its asset and liability cash flows and to provide net interest income growth consistent with the Company's profit objectives. During the year ended December 31, 2011, the Company was able to both increase its net interest income and manage its overall interest rate risk position.

The Company, through its ALCO and ongoing financial management practices monitors the interest rate environment in which it operates and adjusts the rates and maturities of its assets and liabilities to remain competitive and to achieve its overall financial objectives subject to established risk limits. In the current and expected future interest rate environment, the Company has been maintaining its investment portfolio to manage the balance between yield and prepayment risk in its portfolio of mortgage backed securities should interest rates remain at current levels and has been managing the investment portfolio to mitigate extension risk in that same portfolio should interest rates increase. Also, the Company has no call

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risk in its U.S. Agency investment portfolio. During the twelve months ended December 31, 2011, the investment portfolio balance has increased due to both an increase in customer repurchase agreements requiring collateral and to deployment of excess liquidity. Cash flows from maturing mortgaged backed securities were reinvested into a combination of U.S. Agency issues, and pass-through and structured mortgaged backed securities. Additionally, investments have been made in new high quality municipal bonds. The duration of the investment portfolio declined to 3.4 years at December 31, 2011 from 3.9 years at December 31, 2010. In the loan portfolio, the re-pricing duration of the portfolio was 24 months at December 31, 2011, as compared to 11 months at December 31, 2010 due significantly to a change in modeling methodology. Fixed rate loans represented 40% of total loans at December 31, 2011 (37% at December 31, 2010) while variable and adjustable rate loans were 60% of total loans at December 31, 2011 (63% at December 31, 2010). Variable rate loans are indexed primarily to the Wall Street Journal prime interest rate, while adjustable rate loans are indexed primarily to the five-year U.S. Treasury interest rate. In the deposit portfolio, since December 31, 2010, duration has extended to 36 months at December 31, 2011 (32 months at December 31, 2010), as the mix of longer term core demand and money market accounts has increased. Also, longer-term brokered deposits acquired in the first six months of 2011 added duration to term deposits. For the six months ended June 30, 2011, the Company acquired more fixed rate longer-term brokered deposits in anticipation of higher interest rates, which did not occur. For the six months ended December 31, 2011, the growth of core deposits was substantial, which growth enhances franchise value and provides a stable funding source. Core deposits were acquired in a combination of noninterest bearing and money market accounts. Growing core deposits by acquiring new and expanded relationships to the Bank has been a major objective which has been met by the Company over many months, adding liquidity and enhancing asset sensitivity to the year-end 2011 balance sheet. The additional liquidity includes substantially higher amounts of loans held for sale. The re-pricing duration of the deposit portfolio increased to 36 months at December 31, 2011 from 32 months at December 31, 2010, as the mix of deposits shifted from time deposits with relatively short duration to money market and demand accounts with longer effective durations.

The Company has continued its emphasis on funding loans in its marketplace, and has been able to achieve favorable loan pricing, including interest rate floors on many loan originations. These factors have resulted in less pressure on loan yields over the past twelve months, as average interest rates have declined, thereby contributing to enhancing the Company's net interest margin (excluding the effect of the settlement deposit) in 2011 as compared to 2010. Subject to interest rate floor rates, variable and adjustable rate loans provide additional income opportunities should interest rates rise from current levels.

The net unrealized gain before tax on the investment portfolio increased to \$8.1 million at December 31, 2011 from \$3.4 million at December 31, 2010, with realized gains of \$1.4 million recorded for the year ended December 31, 2011. Gains were realized during the year 2011 to both take advantage of a very strong fixed income market and to mitigate prepayment risk in the portfolio of mortgaged backed securities.

There can be no assurance that the Company will be able to successfully achieve its optimal asset liability mix, as a result of competitive pressures, customer preferences and the inability to perfectly forecast future interest rates and movements.

One of the tools used by the Company to manage its interest rate risk is a static GAP analysis presented below. The Company also employs an earnings simulation model on a quarterly basis to monitor its interest rate sensitivity and risk and to model its balance sheet cash flows and the related income statement effects in different interest rate scenarios. The model utilizes current balance sheet data and attributes and is adjusted for assumptions as to investment maturities (including prepayments), loan prepayments, interest rates, and the level of noninterest income and noninterest expense. The data is then subjected to a "shock test" which assumes a simultaneous change in interest rates up 100, 200, 300, and 400 basis points or down 100 and 200, along the entire yield curve, but not below zero. The results are analyzed

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as to the impact on net interest income, net income and the market equity over the next twelve and twenty-four month periods from December 31, 2011.

For the analysis presented below, at December 31, 2011, the simulation assumes a 50 basis point change in interest rates on money market and interest bearing transaction deposits for each 100 basis point change in market interest rates in a decreasing interest rate shock scenario with a floor of 10 basis points, and assumes a 70 basis point change in interest rates on money market and interest bearing transaction deposits for each 100 basis point change in market interest rates in an increasing interest rate shock scenario.

As quantified in the table below, the Company's analysis at December 31, 2011 shows a moderate effect on net interest income (over the next 12 months) as well as the effect on the economic value of equity when interest rates are shocked both down 100 and 200 basis points and up 100, 200, 300, and 400 basis points. This moderate impact is due substantially to the significant level of variable rate and re-priceable assets and liabilities. The re-pricing duration of the investment portfolio at December 31, 2011 is 3.4 years, the loan portfolio 2.0 years; the interest bearing deposit portfolio 2.5 years and the borrowed funds portfolio 1.2 years.

The following table reflects the result of simulation analysis on the December 31, 2011 asset and liabilities balances:

<b>Change in interest rates (basis points)</b>	<b>Percentage change in net interest income</b>	<b>Percentage change in net income</b>	<b>Percentage change in market value of portfolio equity</b>
+400	+11.2%	+31.5%	+0.3%
+300	+7.9%	+22.1%	-0.2%
+200	+3.2%	+9.1%	-0.6%
+100	+0.8%	+2.2%	-0.3%
0			
-100	+3.6%	+10.0%	-4.8%
-200	+4.7%	+13.0%	-8.6%

The results of simulation are well within the policy limits adopted by the Company. For net interest income, the Company has adopted a policy limit of 10% for a 100 basis point change, 12% for a 200 basis point change, 18% for a 300 basis point change and 24% for a 400 basis point change. For the market value of equity, the Company has adopted a policy limit of 12% for a 100 basis point change, 15% for a 200 basis point change, 20% for a 300 basis point change and 25% for a 400 basis point change. The changes in net interest income, net income and the economic value of equity in both a higher and lower interest rate shock scenario at December 31, 2011 are not considered to be material. The positive impact of 0.8% in net interest income and 2.2% in net income given a 100 basis point increase in market interest rates reflects in large measure the higher level of short-term investments added to the balance sheet in the later part of 2011, as deposit growth exceeded loan growth, and the funds were held short-term to meet expected future loan fundings.

During 2011, the Company continued to manage its interest rate sensitivity position to moderate levels of risk, as indicated in the simulation results above. Except for the higher level of asset liquidity at December 31, 2011, the risk position at the end of the year 2011 was similar to the interest rate risk position at December 31, 2010.

Generally speaking, the loss of economic value of portfolio equity in a lower interest rate environment is due to lower values of core deposits more than offsetting the gains in loan and investment values; while the gain of economic value of portfolio equity in a higher interest rate environment is due to higher value of core deposits more than offsetting lower values of fixed rate loans and investments. The Company believes its balance sheet is well positioned in the current interest rate environment.

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Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or re-pricing periods, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that limit changes in interest rates on a short-term basis and over the life of the loan. Further, in the event of a change in interest rates, prepayment and early withdrawal levels could deviate significantly from those assumed. Finally, the ability of many borrowers to service their debt may decrease in the event of a significant interest rate increase.

During 2011, average market interest rates declined as compared to 2010 and the yield curve flattened. The average two year U.S. Treasury rate declined by 25 basis points and the average ten year U.S. Treasury rate declined by 44 basis points. In that environment, the Company was able to increase its net interest spread and margin for 2011 (excluding the impact of the settlement deposit) as compared to 2010. The Company believes that the change in the net interest spread in 2011 as compared to 2010 has been consistent with its risk analysis at December 31, 2010.

**GAP Analysis**

Banks and other financial institutions earnings are significantly dependent upon net interest income, which is the difference between interest earned on earning assets and interest expense on interest bearing liabilities. Net interest income represented 88% of the Company's revenue for the year ended December 31, 2011, as compared to 89% of the Company's revenue for the year ended December 31, 2010. The Company's net interest margin was 3.99% (4.17% excluding the effect of the settlement deposit) as compared to 4.09% for the year ended December 31, 2010. The decrease in the net interest margin for the year ended December 31, 2011 as compared to the year ended December 31, 2010 of 10 basis points (from 4.09% to 3.99%) was due to the settlement deposits being invested at very low interest rates in excess reserves at the Federal Reserve Bank. Excluding the impact of the settlement deposit, the net interest margin was 4.17%, or 8 basis points higher than the net interest margin of 4.09% for the year ended December 31, 2010. Management believes the adjusted net interest margin comparison described above (i.e. excluding the settlement deposit) is more indicative of its net interest margin performance during the year ended December 31, 2011.

In falling interest rate environments, net interest income is maximized with longer term, higher yielding assets being funded by lower yielding short-term funds, or what is referred to as a negative mismatch or GAP. Conversely, in a rising interest rate environment, net interest income is maximized with shorter term, higher yielding assets being funded by longer-term liabilities or what is referred to as a positive mismatch or GAP.

The GAP position, which is a measure of the difference in maturity and re-pricing volume between assets and liabilities, is a means of monitoring the sensitivity of a financial institution to changes in interest rates. The chart below provides an indication of the sensitivity of the Company to changes in interest rates. A negative GAP indicates the degree to which the volume of re-priceable liabilities exceeds re-priceable assets in given time periods.

At December 31, 2011, the Company had a positive GAP position of approximately \$434 million or 15% of total assets out to three months and a positive cumulative GAP position of \$407 million or 14% of total assets out to 12 months; as compared to a positive GAP position of approximately \$399 million or 19% of total assets out to three months and a positive cumulative GAP position of approximately \$265 million or 13% out to 12 months at December 31, 2010. The change in the positive GAP position at December 31, 2011, as compared to December 2010, was due substantially to higher levels of asset liquidity including higher levels of residential mortgage loans held for sale. The change in the GAP position at December 31, 2011 as compared to December 31, 2010 is not judged material to the Company's overall

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interest rate risk position, which relies more heavily on simulation analysis, which captures the full optimality within the balance sheet. The current position is within guideline limits established by the ALCO.

While management believes that this overall position creates a reasonable balance in managing its interest rate risk and maximizing its net interest margin within plan objectives, there can be no assurance as to actual results.

Management has carefully considered its strategy to maximize interest income by reviewing interest rate levels, economic indicators and call features within its investment portfolio (which aspects of risk have been reduced significantly), as well as interest rate floors within its loan portfolio. These factors have been discussed with the ALCO and management believes that current strategies are appropriate to current economic and interest rate trends.

If interest rates increase, the Company's net interest income and net interest margin are expected to increase modestly due to an excess of rate sensitive assets over liabilities, adjusted for the impact of loan floors and the assumption of an increase in money market interest rates by 70% of the change in market interest rates.

If interest rates decline, the Company's net interest income and margin are expected to increase as the floors on the loan portfolio provide added value and variable rate deposits are reduced.

Because competitive market behavior does not necessarily track the trend of interest rates but at times moves ahead of financial market influences, the change in the cost of liabilities may be different than anticipated by the GAP model. If this were to occur, the effects of a declining interest rate environment may not be in accordance with management's expectations.

Table of Contents**GAP Analysis****December 31, 2011****(dollars in thousands)**

<b>Repriceable in:</b>	<b>0-3 months</b>	<b>4-12 months</b>	<b>13-36 months</b>	<b>37-60 months</b>	<b>Over 60 months</b>	<b>Total Rate Sensitive</b>	<b>Non- sensitive</b>	<b>Total Assets</b>
<b>RATE SENSITIVE ASSETS:</b>								
Investment securities	\$ 21,415	\$ 42,217	\$ 92,205	\$ 82,652	\$ 85,564	\$ 324,053		
Loans(1)(2)	1,224,779	188,363	423,947	273,225	122,768	2,233,082		
Fed funds and other short-term investments	232,411					232,411		
Other earning assets	13,743					13,743		