

SEVERN BANCORP INC
Form 10-Q
November 09, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from _____ to _____.

Commission File Number 0-49731

SEVERN BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland

52-1726127

(State or other jurisdiction of incorporation or organization)

(I.R.S. employer identification no.)

200 Westgate Circle, Suite 200

Annapolis, Maryland

21401

(Address of principal executive offices)

(Zip Code)

410-260-2000

(Registrant's telephone number, including area code)

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required

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

Indicate by check mark whether the registrant 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 ☐

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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 definition 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 ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☒

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

Number of shares of the registrant’s Common Stock, \$0.01 par value, outstanding as of the close of business on November 9, 2012: 10,066,679 shares.

SEVERN BANCORP, INC. AND SUBSIDIARIES
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PART I- FINANCIAL INFORMATION

Item 1. Financial Statements

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (UNAUDITED)
(dollars in thousands, except per share data)

	September 30, 2012	December 31, 2011
ASSETS		
Cash and due from banks	\$ 41,793	\$ 35,577
Interest bearing deposits in other banks	40,657	40,610
Federal funds sold	5,886	11,203
Cash and cash equivalents	88,336	87,390
Investment securities held to maturity	36,240	40,357
Loans held for sale	6,794	4,128
Loans receivable, net of allowance for loan losses of \$23,180 and \$25,938, respectively	665,225	693,303
Premises and equipment, net	26,587	27,218
Foreclosed real estate	13,801	19,932
Federal Home Loan Bank stock, at cost	6,520	6,943
Accrued interest receivable and other assets	18,263	21,357
Total assets	\$ 861,766	\$ 900,628
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits	\$ 609,772	\$ 652,757
Long-term borrowings	115,000	115,000
Subordinated debentures	24,119	24,119
Accrued interest payable and other liabilities	5,733	2,822
Total liabilities	754,624	794,698
Stockholders' Equity		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized;		
Preferred stock series "A", 437,500 shares issued and outstanding	4	4
Preferred stock series "B", 23,393 shares issued and outstanding	-	-
Common stock, \$0.01 par value, 20,000,000 shares authorized;		
10,066,679 shares issued and outstanding	101	101

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Additional paid-in capital	74,917	74,683
Retained earnings	32,120	31,142
Total stockholders' equity	107,142	105,930
Total liabilities and stockholders' equity	\$ 861,766	\$ 900,628

The accompanying notes to consolidated financial statements are an integral part of these statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(dollars in thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest Income				
Loans, including fees	\$ 8,878	\$ 10,764	\$ 28,957	\$ 33,340
Securities, taxable	167	170	511	442
Other	59	57	177	161
Total interest income	9,104	10,991	29,645	33,943
Interest Expense				
Deposits	1,779	2,557	6,068	8,053
Long-term borrowings and subordinated debentures	1,248	1,299	3,847	3,875
Total interest expense	3,027	3,856	9,915	11,928
Net interest income	6,077	7,135	19,730	22,015
Provision for loan losses	-	850	465	4,471
Net interest income after provision for loan losses	6,077	6,285	19,265	17,544
Other Income				
Real estate commissions	128	187	488	421
Real estate management fees	147	168	467	469
Mortgage banking activities	521	118	1,232	300
Other	243	155	578	447
Total other income	1,039	628	2,765	1,637
Non-Interest Expenses				
Compensation and related expenses	2,863	2,543	8,853	7,668
Occupancy	189	316	533	872
Foreclosed real estate expenses, net	895	1,242	2,793	4,676
Legal	161	239	511	676
FDIC assessments and regulatory expense	706	553	1,626	1,695
Other	1,338	1,066	4,053	3,252
Total non-interest expenses	6,152	5,959	18,369	18,839

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Income before income tax provision	964	954	3,661	342
Income tax provision	406	403	1,534	190
Net income	558	551	2,127	152
Amortization of discount on preferred stock	(68)	(68)	(203)	(203)
Dividends on preferred stock	(293)	(362)	(948)	(1,087)
Net income (loss) available to common stockholders	\$ 197	\$ 121	\$ 976	\$ (1,138)
Basic earnings (loss) per share	\$.02	\$.01	\$.10	\$ (0.11)
Diluted earnings (loss) per share	\$.02	\$.01	\$.10	\$ (0.11)

The accompanying notes to consolidated financial statements are an integral part of these statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(dollars in thousands)

	For the Nine Months Ended September 30,	
	2012	2011
Cash Flows from Operating Activities		
Net income	\$ 2,127	\$ 152
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred loan fees	(783)	(1,038)
Net amortization of premiums and discounts	146	124
Provision for loan losses	465	4,471
Provision for depreciation	816	936
Gain on sale of loans	(1,232)	(300)
(Gain) loss on sale of foreclosed real estate	(678)	619
Provision for foreclosed real estate	2,819	3,151
Proceeds from loans sold to others	15,360	24,649
Loans originated for sale	(16,794)	(25,921)
Stock-based compensation expense	32	50
Deferred income tax expense (benefit)	1,533	(317)
Decrease in accrued interest receivable and other assets	1,561	1,312
Increase in accrued interest payable and other liabilities	2,911	414
Net cash provided by operating activities	8,283	8,302
Cash Flows from Investing Activities		
Purchase of investment securities held to maturity	(1,045)	(19,447)
Proceeds from maturing investment securities held to maturity	5,000	6,000
Principal collected on mortgage-backed securities held to maturity	16	309
Net decrease in loans	17,458	50,731
Proceeds from sale of foreclosed real estate	15,171	12,134
Investment in foreclosed real estate	(243)	(504)
Investment in premises and equipment	(185)	(98)
Redemption of FHLB Stock	423	552
Net cash provided by investing activities	36,595	49,677

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) CONTINUED
(dollars in thousands)

	For the Nine Months Ended September 30,	
	2012	2011
Cash Flows from Financing Activities		
Net decrease in deposits	\$ (42,985)	\$ (36,059)
Series "A" preferred stock dividend paid	(70)	(210)
Series "B" preferred stock dividend paid	(293)	(877)
Series "B" preferred stock dividend declared not paid	(584)	-
Net cash used in financing activities	(43,932)	(37,146)
Increase in cash and cash equivalents	946	20,833
Cash and cash equivalents at beginning of year	87,390	70,955
Cash and cash equivalents at end of period	\$88,336	\$91,788
Supplemental disclosure of cash flows information:		
Cash paid during period for:		
Interest	\$9,907	\$11,952
Income taxes	\$2	\$476
Transfer of loans to foreclosed real estate	\$10,938	\$13,603

The accompanying notes to consolidated financial statements are an integral part of these statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 - Principles of Consolidation

The unaudited consolidated financial statements include the accounts of Severn Bancorp, Inc. (“Bancorp”), and its wholly-owned subsidiaries, SBI Mortgage Company and SBI Mortgage Company’s subsidiary, Crownsville Development Corporation, and its subsidiary, Crownsville Holdings I, LLC, and Severn Savings Bank, FSB (the “Bank”), and the Bank’s subsidiaries, Louis Hyatt, Inc., Homeowners Title and Escrow Corporation, Severn Financial Services Corporation, SSB Realty Holdings, LLC, SSB Realty Holdings II, LLC, and HS West, LLC. All intercompany accounts and transactions have been eliminated in the accompanying consolidated financial statements.

Note 2 - Basis of Presentation

Bancorp follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the “FASB”. The FASB sets generally accepted accounting principles in the United States (“GAAP”) that Bancorp follows. References to GAAP issued by the FASB in these footnotes are to the FASB Accounting Standards Codification, sometimes referred to as the “Codification” or “ASC”.

The accompanying unaudited consolidated financial statements have been prepared in accordance with GAAP for interim financial information and in accordance with the instructions to Form 10-Q. Accordingly, they do not include all of the disclosures required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation of the results of operations for the interim periods presented have been made. Such adjustments were of a normal recurring nature. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2012 or any other interim period. The unaudited consolidated financial statements for the three and nine months ended September 30, 2012 should be read in conjunction with the audited consolidated financial statements and related notes, which were included in Bancorp’s Annual Report on Form 10-K for the fiscal year ended December 31, 2011. These consolidated financial statements consider events that occurred through the date the consolidated financial statements were issued.

Note 3 - Cash Flow Presentation

In the statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks, Federal Home Loan Bank of Atlanta (“FHLB Atlanta”) overnight deposits, and federal funds sold. Generally, federal funds are sold for one-day periods.

Note 4 - Reclassifications

Amounts in the prior year’s consolidated financial statements have been reclassified whenever necessary to conform to the current year’s presentation. Such reclassifications had no impact on net income.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 5 - Earnings Per Share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding for each period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by Bancorp relate to outstanding stock options, warrants, and convertible preferred stock, and are determined using the treasury stock method.

Not included in the diluted earnings per share calculation for the three and nine month periods ended September 30, 2012, because they were anti-dilutive, were 100,000 shares of common stock issuable upon exercise of outstanding stock options, 556,976 shares of common stock issuable upon the exercise of a warrant and 437,500 shares of common stock issuable upon conversion of Bancorp's Series A Preferred Stock. Not included in the diluted earnings per share calculation for the three and nine month periods ended September 30, 2011, because they were anti-dilutive, were 100,000 shares of common stock issuable upon the exercise of outstanding stock options, 556,976 shares of common stock issuable upon the exercise of a warrant and 437,500 shares of common stock issuable upon conversion of Bancorp's Series A Preferred Stock.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Common shares – weighted average (basic)	10,066,679	10,066,679	10,066,679	10,066,679
Common share equivalents – weighted average	-	-	-	-
Common shares – diluted	10,066,679	10,066,679	10,066,679	10,066,679

Note 6 - Guarantees

Bancorp does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. See Note 10.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 7 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on Bancorp's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. The following table presents the Bank's capital position:

	Actual at September 30, 2012	Actual at December 31, 2011	To Be Well Capitalized Under Prompt Corrective Provisions
Tangible (1)	14.1%	13.0%	N/A
Tier I Capital (2)	18.7%	17.1%	6.0%
Core (1)	14.1%	13.0%	5.0%
Total Capital (2)	20.0%	18.4%	10.0%

(1) To adjusted total assets.

(2) To risk-weighted assets.

Note 8 - Stock-Based Compensation

Bancorp has a stock-based compensation plan for directors, officers, and other key employees of Bancorp. The aggregate number of shares of common stock that may be issued with respect to the awards granted under the plan is 500,000 plus any shares forfeited under Bancorp's old stock-based compensation plan. Under the terms of the stock-based compensation plan, Bancorp has the ability to grant various stock compensation incentives, including stock options, stock appreciation rights, and restricted stock. The stock-based compensation is granted under terms and conditions determined by the Compensation Committee of the Board of Directors. Under the stock-based compensation plan, stock options generally have a maximum term of ten years, and are granted with an exercise price at least equal to the fair market value of the common stock on the date the options are granted. Generally, options granted to directors of Bancorp vest immediately, and options granted to officers and employees vest over a five-year period, although the Compensation Committee has the authority to provide for different vesting schedules.

Bancorp follows FASB ASC 718, "Compensation – Stock Compensation", to account for stock-based compensation. FASB ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statement of operations at fair value. FASB ASC 718 requires an entity to recognize the expense of employee services received in share-based payment transactions and

measure the expense based on the grant date fair value of the award. The expense is recognized over the period during which an employee is required to provide service in exchange for the award.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 8 - Stock-Based Compensation - continued

On March 16, 2010, Bancorp granted 100,000 options to certain officers and employees to purchase shares of Bancorp's stock at a price ranging from \$4.13 to \$4.54 per share. The options vest over a five year period from the date of grant.

The grant-date fair value of options granted was \$2.12. The fair value of the options awarded under the option plan is estimated on the date of grant using the Black-Scholes valuation model, which is dependent upon certain assumptions as presented below:

Expected life of	5.00
options (in years)	
Risk-free interest	2.37%
rate	
Expected volatility	58.78%
Expected dividend	0.00%
yield	

The expected life of the options was estimated using the average vesting period of the options granted and represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the grant date. Volatility of Bancorp's stock price was based on historical volatility. Dividend yield was based on management's projection of future dividends.

Stock-based compensation expense for the three and nine months ended September 30, 2012 totaled \$11,000 and \$32,000, respectively. Stock based compensation expense for the three and nine months ended September 30, 2011 totaled \$21,000 and \$50,000, respectively. There were no options granted or exercised during the nine months ended September 30, 2012 or the nine months ended September 30, 2011.

Information regarding Bancorp's stock-based compensation plan as of and for the nine months ended September 30, 2012 is as follows:

	2012	Weighted Average Price
	Shares	
Options outstanding, December 31, 2011	100,000	\$ 4.21
Options granted	-	-
Options exercised	-	-
Options forfeited	9,000	\$ 4.13
Options outstanding, September 30, 2012	91,000	\$ 4.22
Options exercisable, September 30, 2012	46,259	\$ 4.22

The aggregate intrinsic value of the options outstanding as of September 30, 2012 and December 31, 2011 was \$0.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 8 - Stock-Based Compensation - continued

The following table summarizes the stock options outstanding and exercisable as of September 30, 2012.

Range of Exercise Prices	Number Outstanding	Options Outstanding and Exercisable	
		Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
\$ 4.13	36,092	2.45	\$ 4.13
\$ 4.54	10,167	2.45	\$ 4.54
\$ 4.13-\$4.54	46,259	2.45	\$ 4.22

As of September 30, 2012, there was \$104,000 of total unrecognized stock-based compensation expense related to non-vested stock options, which is expected to be recognized over a period of thirty months.

Note 9 - Investment Securities

The amortized cost and fair value of investment securities held to maturity are as follows:

	Amortized Cost	Gross Unrealized Gains (dollars in thousands)	Gross Unrealized Losses	Fair Value
September 30, 2012:				
US Treasury securities	\$ 31,447	\$ 1,406	\$ -	\$ 32,853
US Agency securities	4,158	85	-	4,243
US Government sponsored mortgage-backed securities	635	59	-	694
Total	\$ 36,240	\$ 1,550	\$ -	\$ 37,790
December 31, 2011:				
US Treasury securities	\$ 34,498	\$ 1,285	\$ (5)	\$ 35,778
US Agency securities	5,206	43	(4)	5,245
US Government sponsored mortgage-backed securities	653	48	-	701
Total	\$ 40,357	\$ 1,376	\$ (9)	\$ 41,724

As of September 30, 2012 and December 31, 2011, there were \$8,417,000 and \$6,432,000, respectively, of US Treasury securities or US Government sponsored mortgage-backed securities pledged by Bancorp as collateral for borrowers' letters of credit with Anne Arundel County.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 9 - Investment Securities - continued

The following tables show fair value and unrealized losses, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position as of September 30, 2012 and December 31, 2011. Included in the table are zero securities in 2012 and two US Treasury securities and one US Agency security in 2011. Management believes that the unrealized losses in 2011 were the result of interest rate levels differing from those existing at the time of purchase of the securities and actual and estimated prepayment speeds. The Bank did not consider any of these securities to be other than temporarily impaired at December 31, 2011, because the unrealized losses were related primarily to changes in market interest rates and widening of sector spreads and were not necessarily related to the credit quality of the issuers of the securities.

In addition, the Bank does not intend to sell, nor does it believe it will be more likely than not that it will be required to sell, any impaired securities prior to a recovery of amortized cost.

	Less than 12 months		12 Months or More		Total	
	Unrealized		Unrealized		Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
September 30, 2012:	(dollars in thousands)					
US Treasury securities	\$ -	\$ (-)	\$ -	\$ (-)	\$ -	\$ (-)
US Agency securities	-	(-)	-	(-)	-	(-)
Total	\$ -	\$ (-)	\$ -	\$ (-)	\$ -	\$ (-)
December 31, 2011:						
US Treasury securities	\$ 2,046	\$ (5)	\$ -	\$ (-)	\$ 2,046	\$ (5)
US Agency securities	1,032	(4)	-	(-)	1,032	(4)
Total	\$ 3,078	\$ (9)	\$ -	\$ (-)	\$ 3,078	\$ (9)

The amortized cost and estimated fair value of debt securities at September 30, 2012, by contractual maturity are shown in the following table. Actual maturities may differ from contractual maturities, because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Held to Maturity (dollars in thousands)	
Amortized Cost	Estimated Fair Value
\$ 5,018	\$ 5,046

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Due in one year or
less

Due from one year to five years	25,520	26,455
Due from five years to ten years	5,067	5,595
US Government sponsored Mortgage-backed securities	635	694
	\$ 36,240	\$ 37,790

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable

Loans receivable consist of the following:	September 30 2012 (dollars in thousands)	December 31 2011
Residential mortgage, total	\$ 279,163	\$ 295,876
Individually evaluated for impairment	51,469	51,007
Collectively evaluated for impairment	227,694	244,869
Construction, land acquisition and development, total	75,274	99,122
Individually evaluated for impairment	15,004	35,398
Collectively evaluated for impairment	60,270	63,724
Land, total	54,863	59,649
Individually evaluated for impairment	9,554	11,384
Collectively evaluated for impairment	45,309	48,265
Lines of credit, total	30,455	34,278
Individually evaluated for impairment	3,039	5,735
Collectively evaluated for impairment	27,416	28,543
Commercial real estate, total	218,231	203,010
Individually evaluated for impairment	13,631	24,354
Collectively evaluated for impairment	204,600	178,656
Commercial non-real estate, total	6,212	5,599
Individually evaluated for impairment	1,869	32
Collectively evaluated for impairment	4,343	5,567
Home equity, total	37,626	41,309
Individually evaluated for impairment	3,515	2,340
Collectively evaluated for impairment	34,111	38,969
Consumer, total	758	897
Individually evaluated for impairment	56	24
Collectively evaluated for impairment	702	873
Total Loans	702,582	739,740
Individually evaluated for impairment	98,137	130,274
Collectively evaluated for impairment	604,445	609,466
Less		

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Loans in process	(12,091)	(18,014)
Allowance for loan losses	(23,180)	(25,938)
Deferred loan origination fees and costs, net	(2,086)	(2,485)
	\$ 665,225	\$ 693,303

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

The inherent credit risks within the portfolio vary depending upon the loan class as follows:

Residential mortgage loans are secured by one to four family dwelling units. The loans have limited risk as they are secured by first mortgages on the unit, which are generally the primary residence of the borrower, at a loan to value ratio of 80% or less.

Construction, land acquisition and development loans are underwritten based upon a financial analysis of the developers and property owners and construction cost estimates, in addition to independent appraisal valuations. These loans will rely on the value associated with the project upon completion. These cost and valuation estimates may be inaccurate. Construction loans generally involve the disbursement of substantial funds over a short period of time with repayment substantially dependent upon the success of the completed project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank is forced to foreclose on a project prior to or at completion, due to a default, there can be no assurance that the Bank will be able to recover all of the unpaid balance of the loan as well as related foreclosure and holding costs. In addition, the Bank may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time. Sources of repayment of these loans typically are permanent financing expected to be obtained upon completion or sales of developed property. These loans are closely monitored by onsite inspections and are considered to be of a higher risk than other real estate loans due to their ultimate repayment being sensitive to general economic conditions, availability of long-term financing, interest rate sensitivity, and governmental regulation of real property.

Land loans are underwritten based upon the independent appraisal valuations as well as the estimated value associated with the land upon completion of development. These cost and valuation estimates may be inaccurate. These loans are considered to be of a higher risk than other real estate loans due to their ultimate repayment being sensitive to general economic conditions, availability of long-term financing, interest rate sensitivity, and governmental regulation of real property.

Line of credit loans are subject to the underwriting standards and processes similar to commercial non-real estate loans, in addition to those underwriting standards for real estate loans. These loans are viewed primarily as cash flow dependent and secondarily as loans secured by real-estate and/or other assets. Repayment of these loans is generally dependent upon the successful operation of the property securing the loan or the principal business conducted on the property securing the loan. Line of credit loans may be adversely affected by conditions in the real estate markets or the economy in general. Management monitors and evaluates line of credit loans based on collateral and risk-rating criteria.

Commercial real estate loans are subject to the underwriting standards and processes similar to commercial and industrial loans, in addition to those underwriting standards for real-estate loans. These loans are viewed primarily as cash flow dependent and secondarily as loans secured by real estate. Repayment of these loans is generally dependent upon the successful operation of the property securing the loan or the principal business conducted on the property securing the loan. Commercial real estate loans may be adversely affected by conditions in the real estate markets or the economy in general. Management monitors and evaluates commercial real estate loans based on collateral and risk-rating criteria. The Bank also utilizes third-party experts to provide environmental and market valuations. The nature of commercial real estate loans makes them more difficult to monitor and evaluate.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

Commercial non-real estate loans are underwritten after evaluating historical and projected profitability and cash flow to determine the borrower's ability to repay their obligation as agreed. Commercial and industrial loans are made primarily based on the identified cash flow of the borrower and secondarily on the underlying collateral supporting the loan facility. Accordingly, the repayment of a commercial and industrial loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary and often insufficient source of repayment.

Home equity loans are subject to the underwriting standards and processes similar to residential mortgages and are secured by one to four family dwelling units. Home equity loans have greater risk than residential mortgages as a result of the Bank being in a second lien position in the event collateral is liquidated.

Consumer loans consist of loans to individuals through the Bank's retail network and are typically unsecured or secured by personal property. Consumer loans have a greater credit risk than residential loans because of the difference in the underlying collateral, if any. The application of various federal and state bankruptcy and insolvency laws may limit the amount that can be recovered on such loans.

The loan portfolio segments and loan classes disclosed above are the same because this is the level of detail management uses when the original loan is recorded and is the level of detail used by management to assess and monitor the risk and performance of the portfolio. Management has determined that this level of detail is adequate to understand and manage the inherent risks within each portfolio segment and loan class.

Allowance for Loan Losses - An allowance for loan losses is provided through charges to income in an amount that management believes will be adequate to absorb losses on existing loans that may become uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Determining the amount of the allowance for loan losses requires the use of estimates and assumptions, which is permitted under GAAP. Actual results could differ significantly from those estimates. Management believes the allowance for losses on loans is adequate. While management uses available information to estimate losses on loans, future additions to the allowances may be necessary based on changes in economic conditions, particularly in the state of Maryland. In addition, various regulatory agencies, periodically review the Bank's allowance for losses on loans as an integral part of their examination process. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. When a real estate secured loan becomes impaired, a decision is made as to whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

For loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

For such loans that are classified as impaired, an allowance is established when the current market value of the underlying collateral, less its estimated disposal costs, is lower than the carrying value of that loan. For loans that are not solely collateral dependent, an allowance is established when the present value of the expected future cash flows of the impaired loan is lower than the carrying value of that loan. The general component relates to loans that are classified as doubtful, substandard or special mention that are not considered impaired, as well as non-classified loans. The general reserve is based on historical loss experience adjusted for qualitative factors. These qualitative factors include:

- Levels and trends in delinquencies and nonaccruals;
 - Inherent risk in the loan portfolio;
 - Trends in volume and terms of the loan;
- Effects of any change in lending policies and procedures;
 - Experience, ability and depth of management;
- National and local economic trends and conditions; and
 - Effect of any changes in concentration of credit.

A loan is considered impaired if it meets either of the following two criteria:

- Loans that are 90 days or more in arrears (nonaccrual loans); or
- Loans where, based on current information and events, it is probable that a borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans, classified special mention, have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

A loan is considered a troubled debt restructuring when for economic or legal reasons relating to the borrowers financial difficulties Bancorp grants a concession to the borrower that it would not otherwise consider. Loan modifications made with terms consistent with current market conditions that the borrower could obtain in the open market are not considered troubled debt restructurings.

Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower,

SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

With respect to all loan segments, management does not charge off a loan, or a portion of a loan, until one of the following conditions have been met:

- The loan has been foreclosed on. Once the loan has been transferred from the Loans Receivable to Foreclosed Real Estate, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.
- An agreement to accept less than the recorded balance of the loan has been made with the borrower. Once an agreement has been finalized, and any proceeds from the borrower are received, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.

Prior to either of the above conditions, a loan is assessed for impairment when: (i) a loan becomes 90 days or more in arrears or (ii) based on current information and events, it is probable that the borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement. If, based on management's assessment of the underlying collateral of the loan, it is determined that a reserve is needed, a specific reserve is recorded. That reserve is included in the Allowance for Loan Losses in the Consolidated Statement of Financial Condition.

Bancorp has experienced an increase in the number of extension requests for commercial real estate and construction loans, some of which have related repayment guarantees. An extension may be granted to allow for the completion of the project, marketing or sales of completed units, or to provide for permanent financing, and is based on a re-underwriting of the loan and management's assessment of the borrower's ability to perform according to the agreed-upon terms. Typically, at the time of an extension, borrowers are performing in accordance with contractual loan terms. Extension terms generally do not exceed 12 to 18 months and typically require that the borrower provide additional economic support in the form of partial repayment, additional collateral or guarantees. In cases where the fair value of the collateral or the financial resources of the borrower are deemed insufficient to repay the loan, reliance may be placed on the support of a guarantee, if applicable. However, such guarantees are not relied on when evaluating a loan for impairment and never considered the sole source of repayment.

Bancorp evaluates the financial condition of guarantors based on the most current financial information available. Most often, such information takes the form of (i) personal financial statements of net worth, cash flow statements and tax returns (for individual guarantors) and (ii) financial and operating statements, tax returns and financial projections (for legal entity guarantors). Bancorp's evaluation is primarily focused on various key financial metrics, including net worth, leverage ratios, and liquidity. It is Bancorp's policy to update such information annually, or more frequently as warranted, over the life of the loan.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable – Continued

While Bancorp does not specifically track the frequency with which it has pursued guarantor performance under a guarantee, its underwriting process, both at origination and upon extension, as applicable, includes an assessment of the guarantor's reputation, creditworthiness and ability to perform. Historically, when Bancorp has found it necessary to seek performance under a guarantee, it has been able to effectively mitigate its losses. When a loan becomes impaired, repayment is sought from both the underlying collateral and the guarantor (as applicable). In the event that the guarantor is unwilling or unable to perform, a legal remedy is pursued.

Construction loans are funded, at the request of the borrower, typically not more than once per month, based on the extent of work completed, and are monitored, throughout the life of the project, by independent professional construction inspectors and Bancorp's commercial real estate lending department. Interest is advanced to the borrower, upon request, based upon the progress of the project toward completion. The amount of interest advanced is added to the total outstanding principal under the loan commitment. Should the project not progress as scheduled, the adequacy of the interest reserve necessary to carry the project through to completion is subject to close monitoring by management. Should the interest reserve be deemed to be inadequate, the borrower is required to fund the deficiency. Similarly, once a loan is fully funded, the borrower is required to fund all interest payments.

Construction loans are reviewed for extensions upon expiration of the loan term. Provided the loan is performing in accordance with contractual terms, extensions may be granted to allow for the completion of the project, marketing or sales of completed units, or to provide for permanent financing. Extension terms generally do not exceed 12 to 18 months.

In general, Bancorp's construction loans are used to finance improvements to commercial, industrial or residential property. Repayment is typically derived from the sale of the property as a whole, the sale of smaller individual units, or by a take-out from a permanent mortgage. The term of the construction period generally does not exceed two years. Loan commitments are based on established construction budgets which represent an estimate of total costs to complete the proposed project including both hard (direct) costs (building materials, labor, etc.) and soft (indirect) costs (legal and architectural fees, etc.). In addition, project costs may include an appropriate level of interest reserve to carry the project through to completion. If established, such interest reserves are determined based on (i) a percentage of the committed loan amount, (ii) the loan term, and (iii) the applicable interest rate. Regardless of whether a loan contains an interest reserve, the total project cost statement serves as the basis for underwriting and determining which items will be funded by the loan and which items will be funded through borrower equity. Bancorp has not advanced additional interest reserves to keep a loan from becoming nonperforming.

Bancorp recognized \$26,000 and \$707,000 of interest income and capitalized interest in its loan portfolio from interest reserves during the nine months ended September 30, 2012 and 2011, respectively. None of the loans where interest reserves were recorded as capitalized interest were non-performing.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following is a summary of the allowance for loan losses for the nine and three month periods ended September 30, 2012 (dollars in thousands):

	Total	Residential Mortgage	Acquisition and Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Nine months September 2012									
Beginning									
Balance	\$ 25,938	\$ 12,303	\$ 3,916	\$ 2,405	\$ 725	\$ 4,157	\$ 169	\$ 2,257	\$ 6
Provision	465	544	(1,656)	1,724	(503)	(465)	894	(88)	15
Charge-offs	(3,333)	(1,646)	(784)	(709)	-	(194)	-	-	-
Recoveries	110	-	-	-	-	-	110	-	-
Ending Balance	\$ 23,180	\$ 11,201	\$ 1,476	\$ 3,420	\$ 222	\$ 3,498	\$ 1,173	\$ 2,169	\$ 21
Ending balance related to:									
Loans individually evaluated for impairment									
	\$ 11,730	\$ 5,261	\$ 1,020	\$ 1,487	\$ 177	\$ 548	\$ 1,103	\$ 2,114	\$ 20
Loans collectively evaluated for impairment									
	\$ 11,450	\$ 5,940	\$ 456	\$ 1,933	\$ 45	\$ 2,950	\$ 70	\$ 55	\$ 1
Three months September 2012									
Beginning									
Balance	\$ 24,097	\$ 11,662	\$ 1,962	\$ 4,536	\$ 239	\$ 3,344	\$ 198	\$ 2,134	\$ 22
Provision	-	(259)	(164)	(723)	(17)	154	975	35	(1)
Charge-offs	(917)	(202)	(322)	(393)	-	-	-	-	-
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	\$ 23,180	\$ 11,201	\$ 1,476	\$ 3,420	\$ 222	\$ 3,498	\$ 1,173	\$ 2,169	\$ 21

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following is a summary of the allowance for loan losses for the nine and three month periods ended September 30, 2011 (dollars in thousands):

	Total	Residential Mortgage	Acquisition and Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Nine months September 2011									
Beginning									
Balance	\$ 29,871	\$ 16,339	\$ 3,997	\$ 4,225	\$ 458	\$ 3,949	\$ 131	\$ 762	\$ 10
Provision	4,471	(900)	3,436	(760)	(52)	871	691	443	742
Charge-offs	(3,984)	(1,921)	(741)	(811)	-	(497)	-	(12)	(2)
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	\$ 30,358	\$ 13,518	\$ 6,692	\$ 2,654	\$ 406	\$ 4,323	\$ 822	\$ 1,193	\$ 750
Ending balance related to:									
Loans individually evaluated for impairment									
	\$ 14,542	\$ 6,514	\$ 3,532	\$ 1,600	\$ 150	\$ 1,055	\$ 159	\$ 791	\$ 741
Loans collectively evaluated for impairment									
	\$ 15,816	\$ 7,004	\$ 3,160	\$ 1,054	\$ 256	\$ 3,268	\$ 663	\$ 402	\$ 9
Three months September 2011									
Beginning									
Balance	\$ 31,103	\$ 13,394	\$ 6,868	\$ 3,679	\$ 395	\$ 4,298	\$ 391	\$ 1,325	\$ 753
Provision	850	512	(23)	(431)	11	485	431	(132)	(3)
Charge-offs	(1,595)	(388)	(153)	(594)	-	(460)	-	-	-
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	\$ 30,358	\$ 13,518	\$ 6,692	\$ 2,654	\$ 406	\$ 4,323	\$ 822	\$ 1,193	\$ 750

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The accrual of interest on loans is discontinued at the time the loan is 90 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued, but not collected, for loans that are placed on non-accrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Bancorp's policy for recording payments received on non-accrual financing receivables is to record the payment towards principal and interest on a cash basis until such time as the loan is returned to accrual status.

The following table presents Bancorp's non-performing assets as of September 30, 2012 and December 31, 2011 (dollars in thousands):

	September 30, 2012	Number of loans	December 31, 2011	Number of loans
Loans accounted for on a non-accrual basis:				
Residential mortgage	\$ 14,028	44	\$ 8,912	25
Acquisition and development	1,004	3	10,997	11
Land	6,020	8	6,813	14
Lines of credit	2,306	5	2,019	4
Commercial real estate	4,430	8	2,140	5
Commercial non-real estate	140	3	5	1
Home equity	2,048	11	343	3
Consumer	46	3	203	4
Total non-accrual loans, excluding troubled debt restructures	\$ 30,022	85	\$ 31,432	67
Accruing loans greater than 90 days past due	\$ -		\$ -	
Nonaccrual troubled debt restructures	\$ 12,574	35	\$ 19,351	38
Foreclosed real-estate	\$ 13,801		\$ 19,932	
Total non-performing assets	\$ 56,397		\$ 70,715	
Accruing troubled debt restructures	\$ 51,230	106	\$ 40,424	77
Total non-accrual loans to net loans	6.4	%	7.3	%

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Allowance for loan losses	\$	23,180		\$	25,938
Allowance to total loans		3.4	%		3.6 %
Allowance for loan losses to total non-performing loans, including loans contractually past due 90 days or more		54.4	%		51.1 %
Total non-accrual and accruing loans greater than 90 days past due to total assets		4.9	%		5.6 %
Total non-performing assets to total assets		6.5	%		7.9 %

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following tables summarize impaired loans at September 30, 2012 and December 31, 2011 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
September 30, 2012					
Residential mortgage	\$ 23,221	\$ 5,261	\$ 28,248	\$ 51,469	\$ 53,233
Acquisition and development	3,683	1,020	11,321	15,004	15,004
Land	3,031	1,487	6,523	9,554	11,226
Lines of credit	445	177	2,594	3,039	3,039
Commercial real estate	3,638	548	9,993	13,631	13,631
Commercial non-real estate	1,869	1,103	-	1,869	1,869
Home equity	2,666	2,114	849	3,515	3,515
Consumer	20	20	36	56	56
T o t a l					
impaired loans	\$ 38,573	\$ 11,730	\$ 59,564	\$ 98,137	\$ 101,573

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
December 31, 2011					
Residential mortgage	\$ 26,736	\$ 5,509	\$ 24,271	\$ 51,007	\$ 51,704
Acquisition and development	18,023	2,624	17,375	35,398	36,261
Land	2,850	1,365	8,534	11,384	12,819
Lines of credit	1,548	510	4,187	5,735	5,735
	4,694	960	19,660	24,354	24,354

Commercial					
real estate					
Commercial					
non-real estate	28	28	4	32	32
Home equity	2,170	1,998	170	2,340	2,340
Consumer	-	-	24	24	24
T o t a l					
impaired loans	\$ 56,049	\$ 12,994	\$ 74,225	\$ 130,274	\$ 133,269

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following tables summarize average impaired loans for the nine and three month periods ended September 30, 2012 and 2011 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Nine months September 30, 2012						
Residential mortgage	\$ 23,294	\$ 638	\$ 28,355	\$ 810	\$ 51,649	\$ 1,448
Acquisition and development	4,309	72	12,310	441	16,619	513
Land	3,043	100	6,659	121	9,702	221
Lines of credit	441	6	2,951	48	3,392	54
Commercial real estate	3,653	120	9,654	333	13,307	453
Commercial non-real estate	1,870	67	-	-	1,870	67
Home equity	2,666	55	850	13	3,516	68
Consumer	20	-	36	-	56	-
Total impaired loans	\$ 39,296	\$ 1,058	\$ 60,815	\$ 1,766	\$ 100,111	\$ 2,824

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three months September 30, 2012						
Residential mortgage	\$ 23,233	\$ 170	\$ 28,270	\$ 243	\$ 51,503	\$ 413
Acquisition and development	4,191	20	11,690	143	15,881	163
Land	3,033	28	6,716	33	9,749	61
Lines of credit	445	1	2,951	12	3,396	13
Commercial real estate	3,641	32	9,607	119	13,248	151

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Commercial						
non-real estate	1,869	23	-	-	1,869	23
Home equity	2,666	21	850	2	3,516	23
Consumer	20	-	36	-	56	-
Total impaired						
loans	\$ 39,098	\$ 295	\$ 60,120	\$ 552	\$ 99,218	\$ 847

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Nine months September 30, 2011						
Residential mortgage	\$ 31,215	\$ 723	\$ 17,996	\$ 587	\$ 49,211	\$ 1,310
Acquisition and development	22,014	674	9,126	216	31,140	890
Land	3,637	141	5,415	94	9,052	235
Lines of credit	604	23	2,597	43	3,201	66
Commercial real estate	4,318	152	15,576	712	19,894	864
Commercial non-real estate	177	-	311	16	488	16
Home equity	888	17	199	4	1,087	21
Consumer	826	-	98	-	924	-
Total impaired loans	\$ 63,679	\$ 1,730	\$ 51,318	\$ 1,672	\$ 114,997	\$ 3,402

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three months September 30, 2011						
Residential mortgage	\$ 31,094	\$ 159	\$ 17,810	\$ 178	\$ 48,904	\$ 337
Acquisition and development	21,560	179	8,986	68	30,546	247
Land	3,627	36	5,414	17	9,041	53
Lines of credit	604	5	2,597	15	3,201	20
Commercial real estate	4,301	45	15,503	225	19,804	270
	177	-	311	-	488	-

Commercial non-real estate						
Home equity	888	4	199	1	1,087	5
Consumer	826	-	98	-	924	-
Total impaired loans	\$ 63,077	\$ 428	\$ 50,918	\$ 504	\$ 113,995	\$ 932

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Changes in impaired loans during the three and nine months ended September 30, 2012 were as follows (dollars in thousands):

	For the three months ended September 30, 2012	For the nine months ended September 30, 2012
Impaired loans at beginning of period	\$ 90,828	\$ 130,274
Added to impaired loans	12,155	22,720
Gross loans transferred to foreclosed real estate	(2,872)	(13,642)
Transferred out of impaired loans	(1,974)	(41,215)
Impaired loans at September 30, 2012	\$ 98,137	\$ 98,137

Bancorp recognized \$847,000 and \$2,824,000 of interest income on impaired loans using a cash-basis method of accounting for the three and nine months ended September 30, 2012. Bancorp did not record any interest income attributable to the change in present value attributable to the passage of time. Bancorp deems its loans to be collateral based, and therefore, assesses impairment based on the net value of the underlying collateral.

Management reviews the status of impaired loans on an ongoing basis. During the quarter ended September 30, 2012, through discussions with our regulators, management determined that approximately \$40.4 million of loans no longer met the definition of impaired loans under ASC 310-10-35. As such, those identified loans have been removed from impaired status.

Included in the above impaired loans amount at September 30, 2012 was \$55,541,000 of loans that are not in non-accrual status. In addition, there was a total of \$51,469,000 of residential real estate loans included in impaired loans at September 30, 2012, of which \$40,429,000 were to consumers and \$11,040,000 to builders. The collateral supporting impaired loans is individually reviewed by management to determine its estimated fair market value, less estimated disposal cost and a specific allowance is established, if necessary, for the difference between the carrying amount of any loan and the estimated fair value of the collateral less estimated disposal cost.

Of the impaired loans, \$38,573,000 and \$56,049,000 had a specific valuation allowance of \$11,730,000 and \$12,994,000 at September 30, 2012 and December 31, 2011, respectively. Impaired loans averaged \$99,218,000 and \$100,111,000 for the three and nine months ended September 30, 2012.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of September 30, 2012 and December 31, 2011 (dollars in thousands):

	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2012					
Residential mortgage	\$ 234,694	\$ 11,070	\$ 33,145	\$ 254	\$ 279,163
Acquisition and development	43,907	9,717	21,650	-	75,274
Land	40,525	6,240	8,098	-	54,863
Lines of credit	23,906	1,708	4,841	-	30,455
Commercial real estate	197,411	6,580	14,136	104	218,231
Commercial non-real estate	4,311	-	1,875	26	6,212
Home equity	33,557	681	3,388	-	37,626
Consumer	703	-	12	43	758
Total loans	\$ 579,014	\$ 35,996	\$ 87,145	\$ 427	\$ 702,582

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2011					
Residential mortgage	\$ 259,359	\$ 8,624	\$ 27,689	\$ 204	\$ 295,876
Acquisition and development	62,054	6,521	30,547	-	99,122
Land	44,443	4,909	10,297	-	59,649
Lines of credit	27,067	1,708	5,503	-	34,278
Commercial real estate	180,635	10,702	11,673	-	203,010
Commercial non-real estate	5,567	-	4	28	5,599
Home equity	38,456	712	2,141	-	41,309
Consumer	874	-	23	-	897

Total loans	\$	618,455	\$	33,176	\$	87,877	\$	232	\$	739,740
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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of September 30, 2012 and December 31, 2011 (dollars in thousands):

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non- Accrual	Total Loans
September 30, 2012							
Residential mortgage	\$240,041	\$12,322	\$7,641	\$-	\$19,963	\$19,159	\$279,163
Acquisition and development	70,618	1,262	-	-	1,262	3,394	75,274
Land	45,293	2,189	-	-	2,189	7,381	54,863
Lines of credit	27,628	249	-	-	249	2,578	30,455
Commercial real estate	207,219	2,406	855	-	3,261	7,751	218,231
Commercial non-real estate	6,068	4	-	-	4	140	6,212
Home equity	34,987	371	120	-	491	2,148	37,626
Consumer	713	-	-	-	-	45	758
Total loans	\$632,567	\$18,803	\$8,616	\$-	\$27,419	\$42,596	\$702,582

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non- Accrual	Total Loans
December 31, 2011							
Residential mortgage	\$261,005	\$9,696	\$4,725	\$-	\$14,421	\$20,450	\$295,876
Acquisition and development	87,369	369	-	-	369	11,384	99,122
Land	49,163	1,517	225	-	1,742	8,744	59,649
Lines of credit	31,889	-	38	-	38	2,351	34,278
Commercial real estate	192,886	2,535	286	-	2,821	7,303	203,010
	5,584	10	-	-	10	5	5,599

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Commercial non-real estate							
Home equity	40,021	945	-	-	945	343	41,309
Consumer	694	-	-	-	-	203	897
Total loans	\$668,611	\$15,072	\$5,274	\$-	\$20,346	\$50,783	\$739,740

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Bancorp offers a variety of modifications to borrowers. The modification categories offered can generally be described in the following categories:

- Rate Modification – A modification in which the interest rate is changed.
- Term Modification – A modification in which the maturity date, timing of payments or frequency of payments is changed.
- Interest Only Modification – A modification in which the loan is converted to interest only payments for a period of time.
- Payment Modification – A modification in which the dollar amount of the payment is changed, other than an interest only modification above.
 - Combination Modification – Any other type of modification, including the use of multiple categories above.

The following tables summarize troubled debt restructurings at September 30, 2012 and December 31, 2011 (dollars in thousands):

September 30, 2012	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Residential mortgage	79	\$ 31,884	\$ 29,877
Acquisition and development	8	13,214	11,595
Land	16	5,929	5,215
Lines of credit	4	593	593
Commercial real estate	12	15,359	8,696
Commercial non-real estate	-	-	-
Home equity	1	100	100
Consumer	-	-	-
Total loans	120	\$ 67,079	\$ 56,076

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted:			
Residential mortgage	17	\$ 5,447	\$ 5,316
Acquisition and development	1	1,830	1,830
Land	2	455	442
Lines of credit	1	140	140

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Commercial real estate	-	-	-
Commercial non-real estate	-	-	-
Home equity	-	-	-
Consumer	-	-	-
Total loans	21	\$ 7,872	\$ 7,728

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

December 31, 2011	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Residential mortgage	68	\$ 30,372	\$ 29,815
Acquisition and development	8	11,152	10,260
Land	9	3,985	3,802
Lines of credit	2	332	332
Commercial real estate	8	8,215	8,046
Commercial non-real estate	-	-	-
Home equity	-	-	-
Consumer	-	-	-
Total loans	95	\$ 54,056	\$ 52,255

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted:			
Residential mortgage	14	\$ 4,568	\$ 4,542
Acquisition and development	1	2,090	2,090
Land	3	464	462
Lines of credit	1	140	140
Commercial real estate	1	288	286
Commercial non-real estate	-	-	-
Home equity	-	-	-
Consumer	-	-	-
Total loans	20	\$ 7,550	\$ 7,520

Bancorp has not purchased, sold or reclassified any loans to held for sale during the periods discussed. Only loans originated specifically for sale are recorded as held for sale at the period ended September 30, 2012 and December 31, 2011.

Bancorp considers a modification of a loan term a TDR if Bancorp for economic or legal reasons related to the borrower's financial difficulties grants a concession to the debtor that it would not otherwise consider. Prior to entering into a loan modification, Bancorp assesses the borrower's financial condition to determine if the borrower has the means to meet the terms of the modification. This includes obtaining a credit report on the borrower as well as the borrower's tax returns and financial statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following tables present newly restructured loans that occurred during the nine and three months ended September 30, 2012 (dollars in thousands):

	Nine months ended September 30, 2012					
	Term		Combination			Total
	Modification	Contracts	Modifications	Contracts	Total	Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	\$ 659	3	\$ 6,347	17	\$ 7,006	20
Acquisition and development	-	-	-	-	-	-
Land	176	1	816	4	992	5
Lines of credit	-	-	-	-	-	-
Commercial real estate	704	3	13,074	3	13,778	6
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	\$ 1,539	7	\$ 20,237	24	\$ 21,776	31
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	\$ 657	3	\$ 6,215	17	\$ 6,872	20
Acquisition and development	-	-	-	-	-	-
Land	176	1	809	4	985	5
Lines of credit	-	-	-	-	-	-
Commercial real estate	689	3	6,530	3	7,219	6
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-

Total loans	\$ 1,522	7	\$ 13,554	24	\$ 15,076	31
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In addition, the collateral securing the TDR, which is always real estate, is evaluated for impairment based on either an appraisal or broker price opinion. If the borrower performs under the terms of the modification, and the ultimate collectability of all amounts contractually due under the modified terms is not in doubt, the loan is returned to accrual status. There are no loans that have been modified due to the financial difficulties of the borrower that are not considered a TDR.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Three months ended September 30, 2012						
	Term		Combination			Total
	Modification	Contracts	Modifications	Contracts	Total	Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	\$ -	-	\$ 258	2	\$ 258	2
Acquisition and development	-	-	-	-	-	-
Land	-	-	282	1	282	1
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	13,074	3	13,074	3
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	\$ -	-	\$ 13,614	6	\$ 13,614	6
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	\$ -	-	\$ 258	2	\$ 258	2
Acquisition and development	-	-	-	-	-	-
Land	-	-	282	1	282	1
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	6,530	3	6,530	3
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	\$ -	-	\$ 7,070	6	\$ 7,070	6

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Interest on TDRs was accounted for under the following methods as of September 30, 2012 and December 31, 2011 (dollars in thousands):

	Number of Contracts	Accrual Status	Number of Contracts	Non-Accrual Status	Total Number of Contracts	Total Modifications
September 30, 2012						
Residential mortgage	79	\$ 30,062	17	\$ 5,131	96	\$ 35,193
Acquisition and development	5	11,035	4	2,390	9	13,425
Land	12	4,296	6	1,361	18	5,657
Lines of credit	3	462	2	272	5	734
Commercial real estate	7	5,375	5	3,320	12	8,695
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	1	100	1	100
Consumer	-	-	-	-	-	-
Total loans	106	\$ 51,230	35	\$ 12,574	141	\$ 63,804
December 31, 2011						
Residential mortgage	57	\$ 22,820	25	\$ 11,537	82	\$ 34,357
Acquisition and development	8	11,962	1	388	9	12,350
Land	6	2,333	6	1,931	12	4,264
Lines of credit	1	140	2	332	3	472
Commercial real estate	5	3,169	4	5,163	9	8,332
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	77	\$ 40,424	38	\$ 19,351	115	\$ 59,775

Management does not charge off a TDR, or a portion of a TDR, until one of the following conditions has been met:

- The loan has been foreclosed on. Once the loan has been transferred from the Loans Receivable to Foreclosed Real Estate, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.
- An agreement to accept less than the face value of the loan has been made with the borrower. Once an agreement has been finalized, and any proceeds from the borrower are received, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.

Prior to either of the above conditions, a loan is assessed for impairment when a loan becomes a TDR. If, based on management's assessment of the underlying collateral of the loan, it is determined that a reserve is needed, a specific reserve is recorded. That reserve is included in the Allowance for Loan Losses in the Consolidated Statement of Financial Condition.

Bancorp performs A note/B note workout structures as a subset of Bancorp's troubled debt restructuring strategy. The amount of loans restructured using this structure was \$2,038,000 at September 30, 2012 and \$1,505,000 at December 31, 2011.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Under an A note/B note workout structure, the new A note is underwritten in accordance with customary troubled debt restructuring underwriting standards and is reasonably assured of full repayment while the B note is not. The B note is immediately charged off upon restructuring.

If the loan was on accrual prior to the troubled debt restructuring being documented with the loan legally divided into an A note fully supporting accrual status and the remainder charged off, the A note may remain on accrual status. If the restructured loan was on nonaccrual status at the time, the A note may be returned to accrual status and risk rated accordingly, after a six month payment performance under the troubled debt restructuring terms.

The A note will continue to be classified as a troubled debt restructuring and may only be removed from impaired status in years after the restructuring if (a) the restructuring agreement specifies an interest rate equal to or greater than the rate that Bancorp was willing to accept at the time of the restructuring for a new loan with a comparable risk and (b) the loan is not impaired based on the terms specified by the restructuring agreement.

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated statement of financial condition. The contract amounts of these instruments express the extent of involvement the Bank has in each class of financial instruments.

The Bank's exposure to credit loss from non-performance by the other party to the above mentioned financial instruments is represented by the contractual amount of those instruments.

The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Unless otherwise noted, the Bank requires collateral or other security to support financial instruments with off-balance-sheet credit risk (dollars in thousands).

Financial Instruments Whose Contract Amounts Represent Credit Risk	Contract Amount At	
	September 30, 2012	December 31, 2011
Standby letters of credit	\$ 16,365	\$ 15,319
Home equity lines of credit	14,026	14,623
Unadvanced construction commitments	11,946	18,014
Mortgage loan commitments	7,909	1,059
Lines of credit	32,689	31,525
Loans sold with limited repurchase provisions	31,358	17,558

Standby letters of credit are conditional commitments issued by the Bank guaranteeing performance by a customer to various municipalities. These guarantees are issued primarily to support performance arrangements, limited to real estate transactions. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of September 30, 2012 and December 31, 2011 for guarantees under standby letters of credit issued is not material.

Home equity lines of credit are loan commitments to individuals as long as there is no violation of any condition established in the contract. Commitments under home equity lines expire ten years after the date the loan closes and are secured by real estate. The Bank evaluates each customer's credit worthiness on a case-by-case basis.

Unadvanced construction commitments are loan commitments made to borrowers for both residential and commercial projects that are either in process or are expected to begin construction shortly. Mortgage loan commitments not reflected in the accompanying statements of financial condition at September 30, 2012 included \$7,359,000 at a fixed

range of 2.75% to 4.125% and \$550,000 at floating rates and at December 31, 2011 included \$1,059,000 at a fixed interest rate range of 3.25% to 5.50% and none at floating interest rates.

Lines of credit are loan commitments to individuals and companies as long as there is no violation of any condition established in the contract. Lines of credit have a fixed expiration date. The Bank evaluates each customer's credit worthiness on a case-by-case basis.

The Bank has entered into several agreements to sell mortgage loans to third parties. The loans sold under these agreements for the nine months ended September 30, 2012 and year ended December 31, 2011 were \$61,557,000 and \$43,403,000, respectively. These agreements contain limited provisions that require the Bank to repurchase a loan if the loan becomes delinquent within the terms specified by the agreement. The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount was recognized in the consolidated statement of financial condition at September 30, 2012 and December 31, 2011 as a liability for credit loss related to these loans.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Bancorp has not purchased, sold or reclassified any loans from loans receivable to loans held for sale during the periods discussed. Only loans, designated specifically for sale are recorded as held for sale at the period ended September 30, 2012 and December 31, 2011.

Note 11 - Fair Values of Financial Instruments

A fair value hierarchy that prioritizes the inputs to valuation methods is used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair market hierarchy are as follows:

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

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

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

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following information should not be interpreted as an estimate of the fair value of Bancorp since a fair value calculation is only provided for a limited portion of Bancorp's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between Bancorp's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of Bancorp's financial instruments at September 30, 2012 and December 31, 2011.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments - Continued

Impaired Loans:

Impaired loans are carried at the lower of cost or the fair value of the collateral for collateral-dependent loans. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The use of independent appraisals and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and impaired loans are therefore classified within level 3 of the fair value hierarchy.

Impaired loans are those for which Bancorp has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consisted of the loan balances of \$38,573,000 and \$56,049,000 at September 30, 2012 and December 31, 2011, respectively, less their valuation allowances of \$11,730,000 and \$12,994,000 at September 30, 2012 and December 31, 2011, respectively.

Foreclosed Real Estate:

Real estate acquired through foreclosure is included in the following disclosure at the lower of carrying value or fair value less estimated disposal costs. Management periodically evaluates the recoverability of the carrying value of the real estate acquired through foreclosure using current estimates of fair value. In the event of a subsequent decline, management provides a specific allowance to reduce real estate acquired through foreclosure to fair value less estimated disposal cost. Expenses incurred on foreclosed real estate prior to disposition are charged to expense. Gains or losses on the sale of foreclosed real estate are recognized upon disposition of the property.

The following table sets forth financial assets that were accounted for at fair value on a nonrecurring basis by level within the fair value hierarchy as of September 30, 2012:

		September 30, 2012 Fair Value Measurement Using:		
		Quoted Prices in Active		
		Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(dollars in thousands)		
Nonrecurring fair value measurements				
Impaired loans	\$ 26,843	\$ -	\$ -	\$ 26,843
Foreclosed real estate	13,801	-	-	13,801
Total nonrecurring fair value measurements	\$ 40,644	\$ -	\$ -	\$ 40,644

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments - Continued

The following table sets forth financial assets that were accounted for at fair value on a nonrecurring basis by level within the fair value hierarchy as of December, 31, 2011:

		December 31, 2011 Fair Value Measurement Using: Quoted Prices in Active Markets For Identical Assets (Level 1) (dollars in thousands)			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	December 31, 2011					
Nonrecurring fair value measurements						
Impaired loans	\$ 43,055	\$ -		\$ -		\$ 43,055
Foreclosed real estate	19,932	-		-		19,932
Total nonrecurring fair value measurements	\$ 62,987	\$ -		\$ -		\$ 62,987

Bancorp did not have any financial assets or liabilities that were required to be measured on a recurring basis at September 30, 2012 or December 31, 2011. There were no liabilities that were required to be re-measured on a nonrecurring basis at September 30, 2012 or December 31, 2011.

For impaired loans, all appraisals are reviewed by the credit department; however, no modifications or adjustments are made to the appraisals received. Modifications or adjustments may be made to appraisals for foreclosed real estate.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which Bancorp has utilized Level 3 inputs to determine fair value:

Fair Value Measurements		Quantitative Information about Level 3		
	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
September 30, 2012				
Impaired loans	\$ 26,843	Appraisal of collateral (1)	Liquidation expenses (2)	-6.00%

Foreclosed real		Appraisal		-5.00% to
estate	\$ 13,801	of collateral	Appraisal	-56.00%
		(1),(3)	adjustments (2)	(-20.76%)

- (1) Fair value is generally determined through independent appraisals for the underlying collateral, which generally include various level 3 inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.
- (3) Includes qualitative adjustments by management and estimated liquidation expenses.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

The following table summarizes the roll forward of level 3 assets for the nine months ended September 30, 2012 and September 30, 2011 (dollars in thousands):

	Impaired Loans	Foreclosed Real Estate
Balance at December 31, 2011	\$ 43,055	\$ 19,932
Transfer to foreclosed real estate	(5,310)	10,938
Additions	12,965	243
Decrease (increase) in additional reserves	1,264	(2,819)
Paid off/sold	(25,131)	(14,493)
Balance at September 30, 2012	\$ 26,843	\$ 13,801

	Impaired Loans	Foreclosed Real Estate
Balance at December 31, 2010	\$ 52,930	\$ 20,955
Transfer to foreclosed real estate	(11,551)	13,603
Additions	28,977	504
Increase in additional reserves	(2)	(3,151)
Paid off/sold	(21,848)	(12,753)
Balance at September 30, 2011	\$ 48,506	\$ 19,158

The \$1,264,000 decrease in additional reserves recorded against impaired loans was included in the provision for loan losses on the statement of operations for the nine months ended September 30, 2012. The \$2,819,000 of additional reserves recorded against foreclosed real estate was included in non-interest expenses on the statement of operations for the nine months ended September 30, 2012. Included in the \$10,938,000 of loans transferred to foreclosed real estate were six loans totaling \$4,095,000 that did not require a specific reserve at the date of transfer from loans to foreclosed assets.

The \$2,000 in additional allowances recorded against impaired loans was included in the provision for loan losses on the statement of operations for the nine months ended September 30, 2011. The \$3,151,000 of additional reserves recorded against foreclosed real estate was included in non-interest expenses on the statement of operations for the nine months ended September 30, 2011. Included in the \$13,603,000 of loans transferred to foreclosed real estate were eleven loans totaling \$4,237,000 that did not require a specific reserve at the date of transfer from loans to foreclosed assets.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

The estimated fair values of Bancorp's financial instruments as of September 30, 2012 and December 31, 2011 were as follows:

			Fair Value Measurement at September 30, 2012		
			Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Carrying Amount	Fair Value	(dollars in thousands)		
Financial Assets					
Cash and cash equivalents	\$ 88,336	\$ 88,336	\$ 88,336	\$ -	\$ -
Investment securities (HTM)	36,240	37,790	-	37,790	-
Loans held for sale	6,794	6,794	-	6,794	-
Loans receivable, net	665,225	725,209	-	-	725,209
FHLB stock	6,520	6,520	-	6,520	-
Accrued interest receivable	2,926	2,926	2,926	-	-
Financial Liabilities					
Deposits	\$ 609,772	\$ 612,103	279,800	332,303	-
FHLB advances	115,000	102,448	-	102,448	-
Subordinated debentures	24,119	24,119	-	24,119	-
Accrued interest payable	707	707	707	-	-
Off Balance Sheet					
Commitments	\$ -	\$ -	\$ -	\$ -	\$ -

December 31, 2011
Carrying Fair

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	Amount	Value
	(dollars in thousands)	
Financial Assets		
Cash and cash equivalents	\$ 87,390	\$ 87,390
Investment securities (HTM)	40,357	41,724
Loans held for sale	4,128	4,128
Loans receivable, net	693,303	743,668
FHLB stock	6,943	6,943
Accrued interest receivable	3,420	3,420
Financial Liabilities		
Deposits	\$ 652,757	\$ 656,854
FHLB advances	115,000	102,260
Subordinated debentures	24,119	24,119
Accrued interest payable	699	699
Off Balance Sheet Commitments		
	\$ -	\$ -

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

The following methods and assumptions were used to measure the fair value of financial instruments recorded at cost on Bancorp's consolidated balance sheet:

Cash and cash equivalents:

The carrying amount reported in the consolidated statements of financial condition for cash and cash equivalents approximate those assets' fair values.

Investment Securities:

Bancorp utilizes a third party source to determine the fair value of its securities. The methodology consists of pricing models based on asset class and includes available trade, bid, other market information, broker quotes, proprietary models, various databases and trading desk quotes. Bancorp's investments are considered Level 2.

Loans held for sale:

The fair value of loans held for sale is based primarily on investor quotes.

Loans receivable:

The fair values of loans receivable were estimated using discounted cash flow analyses, using market interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. These rates were used for each aggregated category of loans as reported on the Office of the Comptroller of the Currency Quarterly Report.

FHLB stock:

The carrying amount of FHLB stock approximates fair value based on the redemption provisions of the FHLB. There have been no identified events or changes in circumstances that may have a significant adverse effect on the FHLB stock. Based on our evaluation, we have concluded that our FHLB stock was not impaired at September 30, 2012 and December 31, 2011.

Accrued interest receivable and payable:

The carrying amounts of accrued interest receivable and accrued interest payable approximates their fair values.

Deposit liabilities:

The fair values disclosed for demand deposit accounts, savings accounts and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

FHLB advances:

Fair values of long-term debt are estimated using discounted cash flow analysis, based on rates currently available for advances from the FHLB with similar terms and remaining maturities.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

Subordinated debentures:

Current economic conditions have rendered the market for this liability inactive. As such, Bancorp is unable to determine a good estimate of fair value. Since the rate paid on the debentures held is lower than what would be required to secure an interest in the same debt at year end and we are unable to obtain a current fair value, Bancorp has disclosed that the carrying value approximates the fair value.

Off-balance sheet financial instruments:

Fair values for Bancorp's off-balance sheet financial instruments (lending commitments and letters of credit) are not significant and are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Note 12 - Recent Accounting Pronouncements

There were no new accounting pronouncements affecting Bancorp during the period that were not already incorporated into the disclosures

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

The Company

Bancorp is a savings and loan holding company chartered as a corporation in the state of Maryland in 1990. It conducts business primarily through two subsidiaries, Severn Savings Bank, FSB ("Bank") and SBI Mortgage Company ("SBI"). The Bank's principal subsidiary Louis Hyatt, Inc. ("Hyatt Commercial"), conducts business as Hyatt Commercial, a commercial real estate brokerage and property management company. SBI holds mortgages that do not meet the underwriting criteria of the Bank, and is the parent company of Crownsville Development Corporation ("Crownsville"), which is doing business as Annapolis Equity Group, which acquires real estate for syndication and investment purposes. The Bank has four branches in Anne Arundel County, Maryland, which offer a full range of deposit products, and originate mortgages in its primary market of Anne Arundel County, Maryland and, to a lesser extent, in other parts of Maryland, Delaware and Virginia.

Bank Competition

The Annapolis, Maryland area has a high density of financial institutions, many of which are significantly larger and have greater financial resources than the Bank, and all of which are competitors of the Bank to varying degrees. The Bank's competition for loans comes primarily from savings and loan associations, savings banks, mortgage banking companies, insurance companies and commercial banks. Its most direct competition for deposits has historically come from savings and loan associations, savings banks, commercial banks and credit unions. The Bank faces additional competition for deposits from money market mutual funds and corporate and government securities funds and investments. The Bank also faces increased competition for deposits from other financial institutions such as brokerage firms and insurance companies. The Bank is a community-oriented financial institution serving its market area with a wide selection of mortgage loan products. Management considers the Bank's reputation and customer

service to be a major competitive advantage in attracting and retaining customers in its market area. The Bank also believes it benefits from its community orientation.

Forward Looking Statements

In addition to the historical information contained herein, the discussion in this report contains forward-looking statements that involve risks and uncertainties and may be affected by various factors that may cause actual results to differ materially from those in the forward-looking statements. The forward-looking statements contained herein include, but are not limited to, those with respect to the Bank's strategy; management's determination of the amount of the loan loss allowance; the effect of changes in interest rates; changes in deposit insurance premiums; ability to meet obligations; and legal proceedings. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "could," "should," "guidance," "potential," "continue," "project," "forecast," "confident," and similar expressions are typically used to identify forward-looking statements. Bancorp's operations and actual results could differ significantly from those discussed in the forward-looking statements. Some of the factors that could cause or contribute to such differences include, but are not limited to: changes in general economic conditions and political conditions and by governmental monetary and fiscal policies; changes in the economic conditions of the geographic areas in which Bancorp conducts business; changes in interest rates; a downturn in the real estate markets in which Bancorp conducts business; the high degree of risk exhibited by Bancorp's loan portfolio; environmental liabilities with respect to properties Bancorp has title; changes in federal and state regulation; the effects of the supervisory agreements entered into by each of Bancorp and the Bank; Bancorp's ability to estimate loan losses; competition; breaches in security or interruptions in Bancorp's information systems; Bancorp's ability to timely develop and implement technology; Bancorp's ability to retain its management team; perception of Bancorp in the market place; Bancorp's ability to maintain effective internal controls over financial reporting and disclosure controls and procedures; and terrorist attacks and threat of actual war; and other factors detailed from time to time in Bancorp's filings with the Securities and Exchange Commission (the "SEC"), including "Item 1A. Risk Factors" contained in Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Critical Accounting Policies

Bancorp's significant accounting policies are set forth in Note 1 of the audited consolidated financial statements as of December 31, 2011 which were included in Bancorp's Annual Report on Form 10-K. Of these significant accounting policies, Bancorp considers its policies regarding the allowance for loan losses and the fair value of foreclosed real estate to be its most critical, because they require management's most subjective and complex judgments. In addition, changes in economic conditions can have a significant impact on the allowance for loan losses and the fair value of foreclosed real estate and therefore on the provision for loan losses and the provision for losses on foreclosed real estate and, ultimately, on results of operations. Bancorp has developed policies and procedures for assessing the adequacy of the allowance for loan losses and the fair value of foreclosed real estate, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio and estimated value of foreclosed real estate. Bancorp's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

Overview

Bancorp provides a wide range of personal and commercial banking services. Personal services include various lending services as well as checking, individual retirement accounts, money market, savings and time deposit accounts. Commercial services include commercial secured and unsecured lending services as well as business internet banking, corporate cash management services and deposit services. Bancorp also provides ATMs, debit cards, internet banking including on-line bill pay, mortgage lending, safe deposit boxes, and telephone banking, among other products and services.

Bancorp experienced net income for the three months ended September 30, 2012, in part due to management's decision to not add to the loan loss reserves during the third quarter. While non-performing assets continued to decrease, and loan delinquencies improved, management elected not to add additional reserves. Bancorp continues to experience challenges it and many other financial institutions face as a result of the weak economic recovery. Some of those challenges, including increased loan delinquencies and a decrease in loan demand have improved from 2008 and 2009, but others, such as declines in the real estate values and financial stress on borrowers as a result of the recession continue. The interest rate spread between Bancorp's cost of funds and what it earns on loans has remained relatively constant from 2010 and 2011 levels.

If interest rates increase, demand for borrowing may decrease and Bancorp's interest rate spread could decrease. Bancorp will continue to manage loan and deposit pricing against the risks of rising costs of its deposits and borrowings. Interest rates are outside the control of Bancorp, so it must attempt to balance its pricing and duration of its loan portfolio against the risks of rising costs of its deposits and borrowings.

The continued success and attraction of Anne Arundel County, Maryland, and vicinity, will also be important to Bancorp's ability to originate and grow mortgage loans and deposits, as will Bancorp's continued focus on maintaining a low overhead.

If the volatility in the market and the economy continues or worsens, our business, financial condition, results of operations, access to funds and the price of our stock could be materially and adversely impacted.

Results of Operations

Net income increased by \$7,000 to net income of \$558,000 for the third quarter of 2012, compared to a net income of \$551,000 for the third quarter of 2011. Basic and diluted earnings per share were \$.02 for the third quarter of 2012 compared to \$0.01 for the third quarter of 2011. The increase in net income and basic and diluted earnings per share over last year was primarily the result of management's decision to add approximately \$850,000 to the loan loss reserve during the third quarter of 2011, while no loan loss reserve provision was added during the third quarter of 2012. Net income increased by \$1,975,000 to net income of \$2,127,000 for the nine months ended September 30, 2012, compared to a net income of \$152,000 for the nine months ended September 30, 2011. Basic and diluted earnings (loss) per share increased by \$.21, to \$.10 for the nine months ended September 30, 2012 compared to \$(.11) for the nine months ended September 30, 2011. The increase in net income and basic and diluted earnings per share over last year was primarily the result of management's decision to add approximately \$4,471,000 to the loan loss reserve during the nine months ended September 30, 2011 compared to \$465,000 in loan loss reserve provision added during the nine months ended September 30, 2012.

Net interest income, which is interest earned net of interest expense, decreased by \$1,058,000, or 14.8%, to \$6,077,000 for the third quarter of 2012, compared to \$7,135,000 for the third quarter of 2011. The primary reason for the decrease in net interest income was a decrease in Bancorp's loan portfolio and a decrease in yield on the loan portfolio, partially offset by a lower cost of funds. Net interest income decreased \$2,285,000, or 10.4%, to \$19,730,000 for the nine months ended September 30, 2012, compared to \$22,015,000 for the nine months ended September 30, 2011. The primary reason for the decrease in net interest income was a decrease in Bancorp's loan portfolio and a decrease in yield on the loan portfolio, partially offset by a lower cost of funds.

Bancorp's loan portfolio is subject to varying degrees of credit risk and an allowance for loan losses is maintained to absorb losses inherent in its loan portfolio. Credit risk includes, but is not limited to, the potential for borrower default and the failure of collateral to be worth what Bancorp determined it was worth at the time of the granting of the loan. Bancorp monitors its loan delinquencies at least monthly. All loans that are delinquent and all loans within the various categories of Bancorp's portfolio as a group are evaluated. Bancorp's Board, with the advice and

recommendation of Bancorp's loss mitigation committee, estimates an allowance to be set aside for loan losses. Included in determining the calculation are such factors as historical losses for each loan portfolio, current market value of the loan's underlying collateral, inherent risk contained within the portfolio after considering the state of the general economy, economic trends, consideration of particular risks inherent in different kinds of lending and consideration of known information that may affect loan collectability.

The provision for loan losses decreased by \$850,000, or 100.0%, to zero for the third quarter of 2012, compared to \$850,000 for the third quarter of 2011. This decrease was a result of management's decision not to add to the provision for loan losses during the quarter ended September 30, 2012, compared to the quarter ended September 30, 2011. The provision for loan losses decreased by \$4,006,000, or 89.6%, to \$465,000 for the nine months ended September 30, 2012, compared to \$4,471,000 for the same period in 2011. Bancorp's total loan portfolio has decreased from 2011.

Total other income increased by \$411,000, or 65.4%, to \$1,039,000 for the third quarter of 2012, compared to \$628,000 for the third quarter of 2011. The primary reason for the increase in other income was an increase in mortgage banking activities. Total other income increased by \$1,128,000, or 68.9%, to \$2,765,000 for the nine months ended September 30, 2012, compared to \$1,637,000 for the same period in 2011. Real estate commissions decreased \$59,000, or 31.6%, to \$128,000 for the third quarter of 2012, compared to \$187,000 for the third quarter of 2011. This decrease was due to lower sales and leasing activity in the third quarter of 2012 compared to the comparable quarter in 2011. Real estate commissions increased \$67,000, or 15.9%, to \$488,000 for the nine months ended September 30, 2012, compared to \$421,000 for the same period in 2011. Real estate management fees decreased \$21,000, or 12.5%, to \$147,000 for the third quarter of 2012, compared to \$168,000 for the third quarter of 2011. Real estate management fees decreased \$2,000, or 0.4%, to \$467,000 for the nine months ended September 30, 2012, compared to \$469,000 for the same period in 2011. Mortgage banking activities increased \$403,000, or 341.5%, to \$521,000 for the third quarter of 2012, compared to \$118,000 for the third quarter of 2011. This increase was due to an increase of loans sold on the secondary market, primarily from the E-Home finance department, in the third quarter of 2012 compared to the third quarter of 2011. Mortgage banking activities increased by \$932,000, or 310.7%, to \$1,232,000 for the nine months ended September 30, 2012, compared to \$300,000 for the same period in 2011.

Total non-interest expenses increased \$193,000, or 3.2%, to \$6,152,000 for the third quarter of 2012, compared to \$5,959,000 for the third quarter of 2011. Total non-interest expenses decreased \$470,000, or 2.5%, to \$18,369,000 for the nine months ended September 30, 2012, compared to \$18,839,000 for the same period in 2011. Compensation and related expenses increased by \$320,000, or 12.6%, to \$2,863,000 for the third quarter of 2012, compared to \$2,543,000 for the third quarter of 2011. Compensation and related expenses increased by \$1,185,000, or 15.5%, to \$8,853,000 for the nine months ended September 30, 2012, compared to \$7,668,000 for the same period in 2011. This increase was primarily because of vacated and additional positions being filled by newly hired employees during the first nine months of 2012. Net occupancy costs decreased by \$127,000, or 40.2%, to \$189,000 for the third quarter of 2012, compared to \$316,000 for the third quarter of 2011. Net occupancy costs decreased by \$339,000, or 38.9%, to \$533,000 for the nine months ended September 30, 2012, compared to \$872,000 for the same period in 2011. This decrease was the result of increased rents collected on previously unoccupied space which helped offset occupancy costs. Foreclosed real estate expenses, net decreased by \$347,000, or 27.9%, to \$895,000 for the third quarter of 2012, compared to \$1,242,000 for the third quarter of 2011. Foreclosed real estate expenses, net decreased by \$1,883,000, or 40.3%, to \$2,793,000 for the nine months ended September 30, 2012, compared to \$4,676,000 for the same period in 2011. These differences were the result of lower write downs and higher foreclosed real estate sale gains during the nine months of 2012. Legal fees decreased by \$78,000, or 32.6%, to \$161,000 for the third quarter of 2012, compared to \$239,000 for the third quarter of 2011. Legal fees decreased \$165,000, or 24.4%, to \$511,000 for the nine months ended September 30, 2012, compared to \$676,000 for the same period in 2011. These decreases were the result of Bancorp's ability during 2012 to utilize employees for certain services previously provided by outside legal firms. FDIC assessments and regulatory expense increased by \$153,000, or 27.7% to \$706,000 for the third quarter of 2012, compared to \$553,000 for the third quarter of 2011. FDIC assessments and regulatory expense decreased by \$69,000, or 4.1% to \$1,626,000 for the nine months ended September 30, 2012, compared to \$1,695,000 for the same period in 2011. Other non-interest expenses increased by \$272,000, or 25.5%, to \$1,338,000 for the third quarter of 2012 compared to \$1,066,000 for the third quarter of 2011. Other non-interest expenses increased by \$801,000, or 24.6%, to \$4,053,000 for the nine months ended September 30, 2012 compared to \$3,252,000 for the same period in 2011.

Income Taxes

Income tax expense increased by \$3,000 to an income tax provision of \$406,000 for the third quarter of 2012 compared to an income tax provision of \$403,000 for the third quarter of 2011. The increase was consistent with the increase in pretax income compared to pretax income for the third quarter of 2011. The effective tax rate for the third quarter of 2011 was 42.1% compared to 42.2% for the third quarter of 2011. Income tax expense increased by \$1,344,000 to an income tax provision of \$1,534,000 for the nine months ended September 30, 2012 compared to an income tax provision of \$190,000 for the same period in 2011. The effective tax rate for the nine months ended September 30, 2012 was 41.9% compared to 55.6% for the same period in 2011. The change in the effective tax rates was primarily due to a valuation allowance placed on a portion of the deferred tax asset resulting from current state operating loss carryforwards.

Analysis of Financial Condition

Total assets decreased \$38,862,000 to \$861,766,000 at September 30, 2012, compared to \$900,628,000 at December 31, 2011. Cash and cash equivalents increased by \$946,000, or 1.1%, to \$88,336,000 at September 30, 2012, compared to \$87,390,000 at December 31, 2011. This increase was primarily in cash and due from bank balances. The loan portfolio decreased, as net loans receivable decreased \$28,078,000, or 4.0%, to \$665,225,000 at September 30, 2012, compared to \$693,303,000 at December 31, 2011. This decrease was the result of the continued general slowdown in loan demand during the first nine months of 2012 and the transfer of \$10,938,000 of net loans to foreclosed real estate. Loans held for sale increased \$2,666,000, or 64.6%, to \$6,794,000 at September 30, 2012, compared to \$4,128,000 at December 31, 2011. This increase was primarily due to the timing of loans pending sale as of September 30, 2012. Foreclosed real estate decreased \$6,131,000, or 30.8%, to \$13,801,000 at September 30, 2012 compared to \$19,932,000 at December 31, 2011. This decrease was the result of an increase in foreclosed property sales during the first nine months of 2012 compared to the first nine months of 2011. Total deposits decreased \$42,985,000, or 6.6%, to \$609,772,000 at September 30, 2012 compared to \$652,757,000 at December 31, 2011. These changes were primarily the result of Bancorp's continued monitoring of the deposit portfolio and allowing higher rate deposits to leave. Long-term borrowings remained at \$115,000,000 at September 30, 2012 and December 31, 2011. These borrowings do not mature until 2016 or later and would incur prepayment penalties if paid earlier.

Stockholders' Equity

Total stockholders' equity increased \$1,212,000 to \$107,142,000 at September 30, 2012 compared to \$105,930,000 as of December 31, 2011. This increase was primarily a result of the decrease in dividends paid to Bancorp's preferred stockholders and net income for the first nine months of 2012.

Liquidity

Bancorp's liquidity is determined by its ability to raise funds through several sources including borrowed funds, capital, deposits, loan repayments, maturing investments and the sale of loans.

In assessing its liquidity, the management of Bancorp considers operating requirements, anticipated deposit flows, expected funding of loans, deposit maturities and borrowing availability, so that sufficient funds may be available on short notice to meet obligations as they arise or to permit Bancorp to take advantage of business opportunities.

Management believes Bancorp has sufficient cash flow and liquidity to meet its current commitments through the next 12 months. Certificates of deposit, which are scheduled to mature in less than one year, totaled \$203,538,000 at September 30, 2012. Based on past experience, management believes that a significant portion of such deposits will remain with Bancorp. At September 30, 2012, Bancorp had commitments to originate mortgage loans of \$7,909,000, unadvanced home equity lines of credit of \$14,026,000, unadvanced construction commitments of \$11,946,000, unused lines of credit of \$32,389,000 and commitments under standby letters of credit of \$16,365,000. Bancorp has the ability to reduce its commitments for new loan originations, adjust other cash outflows, and borrow from FHLB Atlanta should the need arise. As of September 30, 2012, outstanding FHLB Atlanta borrowings totaled \$115,000,000, and Bancorp had available to it an additional \$63,290,000 in borrowing availability from FHLB Atlanta.

Net cash provided by operating activities decreased \$19,000 to \$8,283,000 for the nine months ended September 30, 2012, compared to \$8,302,000 for the same period in 2011. This decrease was primarily the result of a net decrease in loans originated and sold in 2012 and a decrease in accrued interest receivable and other assets, partially offset by a gain on loans sold and net income generated in the current period. Net cash provided by investing activities decreased \$13,082,000 to \$36,595,000 for the nine months ended September 30, 2012, compared to \$49,677,000 provided by investing activities for the same period in 2011. This decrease was primarily due to a decrease in loans in 2012 compared to the same period in 2011. Net cash used in financing activities was \$43,932,000 for the nine months ended September 30, 2012, compared to \$37,146,000 for the same period in 2011. This decrease was primarily due to a larger decrease in deposits in 2012 compared to the same period in 2011.

Federal Home Loan Bank of Atlanta Line of Credit

The Bank has an available line of credit, secured by various loans in its portfolio, in the amount of twenty percent of its total assets, with the FHLB Atlanta. As of September 30, 2012, the total available line of credit with the FHLB Atlanta was approximately \$178,290,000, of which \$115,000,000 was outstanding in the form of long-term borrowings. The Bank, from time to time, utilizes the line of credit when interest rates are more favorable than obtaining deposits from the public.

During the third quarter 2012, the Bank restructured a portion of its FHLB Atlanta borrowings by repaying \$65 million of existing advances and replacing them with \$65 million of lower cost advances. The transaction resulted in \$5.3 million in prepayment penalties that were deferred and will be recognized in interest expense through yield adjustments on the new borrowings in future periods. The existing borrowings had an average cost of 3.87%. The new borrowings had an average cost of 2.72% including the deferred adjustment. The relevant accounting treatment for this transaction was provided in ASC 470-50. This transaction was executed as an earnings strategy.

The following table sets forth information concerning the interest rates and maturity dates of the advances from the FHLB Atlanta as of September 30, 2012 (dollars in thousands):

Principal Amount	Rate	Maturity
\$ -	-%	2012
-	-%	2013
-	-%	2014
-	-%	2015
	1.81%	
	to	
15,000	1.83%	2016
	2.43%	
	to	
100,000	4.05%	Thereafter
\$ 115,000		

Subordinated Debentures

As of September 30, 2012, Bancorp had outstanding \$20,619,000 principal amount of Junior Subordinated Debt Securities Due 2035 (the “2035 Debentures”). The 2035 Debentures were issued pursuant to an Indenture dated as of December 17, 2004 (the “2035 Indenture”) between Bancorp and Wells Fargo Bank, National Association, as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of LIBOR (0.45510% as of September 30, 2012) plus 200 basis points, and mature on January 7, 2035. Payments of principal, interest, premium and other amounts under the 2035 Debentures are subordinated and junior in right of payment to the prior payment in full of all senior indebtedness of Bancorp, as defined in the 2035 Indenture. The 2035 Debentures became redeemable, in whole or in part, by Bancorp on January 7, 2010.

The 2035 Debentures were issued and sold to Severn Capital Trust I (the “Trust”), of which 100% of the common equity is owned by Bancorp. The Trust was formed for the purpose of issuing corporation-obligated mandatorily redeemable Capital Securities (“Capital Securities”) to third-party investors and using the proceeds from the sale of such Capital Securities to purchase the 2035 Debentures. The 2035 Debentures held by the Trust are the sole assets of the Trust. Distributions on the Capital Securities issued by the Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Trust on the 2035 Debentures. The Capital Securities are subject to mandatory redemption, in whole or in part, upon repayment of the 2035 Debentures. Bancorp has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee.

On November 15, 2008, Bancorp completed a private placement offering consisting of a total of 70 units, at an offering price of \$100,000 per unit, for gross proceeds of \$7.0 million. Each unit consists of 6,250 shares of Bancorp's Series A 8.0% Non-Cumulative Convertible Preferred Stock and Bancorp's Subordinated Note in the original principal amount of \$50,000.

The aggregate principal amount of Subordinated Notes outstanding at September 30, 2012 was \$3,500,000. The Subordinated Notes earn interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31,

2018. Debt issuance costs totaled \$245,000 and are being amortized over 10 years.

Preferred Stock

Bancorp issued a total of 437,500 shares of its Series A 8.0% Non-Cumulative Convertible Preferred Stock ("Series A Preferred Stock") as part of the private placement offering completed on November 15, 2008. The liquidation preference is \$8.00 per share. Each share of Series A Preferred Stock is convertible at the option of the holder into one share of Bancorp's common stock, subject to adjustment upon certain corporate events. The initial conversion rate is equivalent to an initial conversion price of \$8.00 per share of Bancorp's common stock. At the option of Bancorp, on and after December 31, 2013, at any time and from time to time, some or all of the Series A Preferred Stock may be converted into shares of Bancorp's common stock at the then-applicable conversion rate. Costs related to the issuance of the preferred stock totaled \$247,000 and were netted against the proceeds.

If declared by Bancorp's board of directors, cash dividends at an annual rate of 8.0% will be paid quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. Dividends will not be paid on Bancorp's common stock in any quarter until the dividend on the Series A Preferred Stock has been paid for such quarter; however, there is no requirement that Bancorp's board of directors declare any dividends on the Series A Preferred Stock and any unpaid dividends shall not be cumulative.

On November 21, 2008, Bancorp entered into an agreement with the United States Department of the Treasury ("Treasury"), pursuant to which Bancorp issued and sold (i) 23,393 shares of its Series B Fixed Rate Cumulative Perpetual Preferred Stock, par value \$0.01 per share and liquidation preference \$1,000 per share, (the "Series B Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 556,976 shares of Bancorp's common stock, par value \$0.01 per share, for an aggregate purchase price of \$23,393,000. Costs related to the issuance of the preferred stock and warrants totaled \$45,000 and were netted against the proceeds.

The Series B Preferred Stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series B Preferred Stock has no maturity date and ranks *pari passu* with Bancorp's existing Series A Preferred Stock, in terms of dividend payments and distributions upon liquidation, dissolution and winding up of Bancorp.

The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, Bancorp's authorized number of directors will be automatically increased by two and the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, will have the right to elect those directors at Bancorp's next annual meeting of stockholders or at a special meeting of stockholders called for that purpose. These preferred share directors will be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid.

The Warrant has a 10-year term and is immediately exercisable at an exercise price of \$6.30 per share of Common Stock. The exercise price and number of shares subject to the Warrant are both subject to anti-dilution adjustments. Pursuant to the Purchase Agreement, Treasury has agreed not to exercise voting power with respect to any shares of Common Stock issued upon exercise of the Warrant.

Bancorp's ability to declare dividends on its common stock are limited by the terms of Bancorp's Series A preferred stock and Series B preferred stock. Bancorp may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to its common stock in any quarter until the dividend on the Series A Preferred Stock has been declared and paid for such quarter, subject to certain minor exceptions.

On November 23, 2009, Bancorp and the Bank entered into supervisory agreements with its regulators. The agreements require, among other things, that Bancorp and the Bank must obtain prior regulatory approval before any dividends or capital distributions can be made.

The Bancorp has deferred two dividend payments on the Series B Preferred Stock held by the U.S. Treasury. On September 30, 2012, the cumulative amount of dividends in arrears not declared, including interest on unpaid dividends at 5% per annum was \$588,000.

Effects of Inflation

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry which require the measurement of financial condition and operating results in terms of historical dollars, without considering the changes in the relative purchasing power of money over time due to inflation. Unlike industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

Average Balance Sheet

The following table presents Bancorp's distribution of the average consolidated balance sheets and net interest analysis for the nine months ended September 30, 2012 and 2011:

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	Nine Months Ended September 30, 2012				Nine Months Ended September 30, 2011			
	Average Volume	Interest	Yield/Cost		Average Volume	Interest	Yield/Cost	
(dollars in thousands)								
ASSETS								
Loans (1)	\$ 696,410	\$ 28,957	5.54	%	\$ 763,287	\$ 33,340	5.82	%
Held to maturity securities (2)	38,341	511	1.78	%	36,257	442	1.63	%
Other interest-earning assets (3)	72,437	177	0.33	%	61,832	161	0.35	%
Total interest-earning assets	807,188	29,645	4.90	%	861,376	33,943	5.25	%
Non-interest earning assets	82,309				86,665			
Total assets	\$ 889,497				\$ 948,041			
LIABILITIES AND STOCKHOLDERS' EQUITY								
Savings and checking deposits	\$ 274,904	886	0.43	%	\$ 288,766	1,767	0.82	%
Certificates of deposit	364,404	5,182	1.90	%	410,002	6,286	2.04	%
Borrowings	139,119	3,847	3.69	%	139,119	3,875	3.71	%
Total interest-bearing liabilities	778,427	9,915	1.70	%	837,887	11,928	1.90	%
Non-interest bearing liabilities	5,008				4,203			
Stockholders' equity	106,062				105,951			
Total liabilities and stockholders' equity	\$ 889,497				\$ 948,041			
Net interest income and interest rate spread		\$ 19,730	3.20	%		\$ 22,015	3.35	%
Net interest margin			3.26	%			3.41	%

Average interest-earning assets to average interest-bearing liabilities	103.69 %	102.80 %
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- (1) Non-accrual loans are included in the average balances and in the computation of yields.
- (2) Bancorp does not have any tax-exempt securities.
- (3) Other interest-earning assets includes interest-bearing deposits in other banks, federal funds sold and FHLB stock investments.

Recent Accounting Pronouncements

For information concerning recent accounting pronouncements, see Note 12 to the unaudited Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in market risk since December 31, 2011, as reported in Bancorp's Form 10-K filed with the SEC on March 15, 2012.

Item 4. Controls and Procedures

Under the supervision and with the participation of Bancorp's management, including its Chief Executive Officer and Chief Financial Officer, Bancorp has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2012. Based upon this evaluation, Bancorp's Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2012, Bancorp's disclosure controls and procedures were effective in reaching a reasonable level of assurance that (i) information required to be disclosed by Bancorp in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) information required to be disclosed by Bancorp in its reports that it files or submits under the Exchange Act is accumulated and communicated to its management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There have not been any changes in Bancorp's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, Bancorp's internal control over financial reporting.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Bancorp have been detected. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

There are various claims pending involving Bancorp, arising in the normal course of business. Management believes, based upon consultation with legal counsel, that liabilities arising from these proceedings, if any, will not be material to Bancorp's consolidated financial condition and consolidated results of operations.

Item 1A. Risk Factors

The risk factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 should be carefully considered by you. If any of the risks actually occur, Bancorp’s business, financial condition or results of operations could be materially and adversely affected. The risks described in our Annual Report on Form 10-K are not the only risks facing Bancorp. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or results of operations. This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Bancorp’s actual results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by Bancorp described in Bancorp’s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

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

None.

Item 3. Defaults Upon Senior Securities

As noted above, Bancorp and the Bank entered into supervisory agreements with the regulators that require, among other things, that Bancorp and Bank obtain prior regulatory approval before paying any dividends or distribution. During the third quarter of 2012, Bancorp did not receive approval from the Federal Reserve Bank of Richmond to pay dividends on the Series B Preferred Stock in the amount of \$293,000 due on August 15, 2012 and Series A Preferred Stock in the amount of \$70,000 due on September 30, 2012. On September 30, 2012, Bancorp has unpaid cumulative dividends and interest in arrears on the Series B Preferred Stock of \$588,000.

Bancorp and Bank continue to work with the regulators to obtain approval for dividends and interest payments.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Description
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31.1	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
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31.2	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
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32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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101 The following financial statements from the Severn Bancorp, Inc. Quarterly Report on Form 10-Q as of September 30, 2012 and for the three and nine months ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Condition; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; and (iv) the Notes to Consolidated Financial Statements. Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

SEVERN BANCORP, INC.

November 9, 2012

Alan J. Hyatt _____
Alan J. Hyatt, Chairman of the Board, President and Chief
Executive Officer
(Principal Executive Officer)

November 9, 2012

Stephen W. Lilly _____
Stephen W. Lilly,
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit Index

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