Howard Bancorp Inc
Form 10-K
March 27, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2013

Commission file number: 001-35489

HOWARD BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland	**20-3735949**
State or other jurisdiction	(I.R.S. Employer
of incorporation or organization	Identification No.)

6011 University Blvd. Suite 370, Ellicott City, MD 21043

(Address of principal executive offices) (Zip Code)

(410) 750-0020

(Registrant’s telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	The NASDAQ Stock Market LLC

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes ¨ No x

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

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 x No ¨

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “small reporting company” in Rule 12b-2 of the Exchange Act.

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

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

The aggregate market value of the voting common stock of the registrant held by non-affiliates on June 30, 2013, was approximately $24.0 million. At February28, 2014, the number of outstanding shares of Common Stock, $0.01 par value, of the Corporation was 4,090,402.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Form 10-K incorporates by reference certain information from the registrant’s definitive Proxy Statement for the 2014 Annual Meeting of Stockholders.

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As used in this report, “the Company,” “we,” “us,” and “ours” refer to Howard Bancorp, Inc. and its subsidiaries. References to the “Bank” refer to Howard Bank.

This report contains forward-looking statements, which can be identified by the use of words such as “estimate,” “project,” “believe,” “intend,” “anticipate,” “plan,” “seek,” “expect,” “will,” “may,” “should” and words of similar meaning. You can also them by the fact that they do not relate strictly to historical or current facts.

These forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations, particularly with respect to our business plan and strategies, including branch expansion and closures, market share and asset growth, revenue and profit growth, expanding client relationships, increasing originations of residential mortgage loans, our portfolio of mortgage loans and our selling of loans into the secondary market;
- anticipated changes in expenses and net income;
- acquisition intensions;
- statements regarding the asset quality of our investment portfolios and anticipated recovery and collection of unrealized losses on securities available for sale;
- statements with respect to our allowance for credit losses, and the adequacy thereof;
- statements with respect to anticipated losses on nonperforming loans;
- statement with respect to having adequate liquidity levels;
- our belief that we will retain a large portion of maturing certificates of deposit;
- the impact on us of recent changes to accounting standards;
- future cash requirements relating to commitments to extend credit; and
- the impact of interest rate changes on our net interest income.

These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. We are under no duty to and do not undertake any obligation to update any forward-looking statements after the date of this report.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- adverse changes in the securities markets;

- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- our ability to enter new markets successfully and capitalize on growth opportunities, and to otherwise implement our growth strategy;
- our ability to successfully integrate acquired entities, if any;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board;
- changes in our organization, compensation and benefit plans
- loss of key personnel; and
- other risk discussed in this report.

Because of these and a wide variety of other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. You should not put undue reliance on any forward-looking statements.

Part I

Item 1. Business

Howard Bancorp, Inc.

Howard Bancorp, Inc. was incorporated in April of 2005 under the laws of the State of Maryland and is a bank holding company registered under the Bank Holding Company Act of 1956. On May 18, 2005, the stockholders of Howard Bank approved the reorganization of Howard Bank into a holding company structure. The reorganization became effective on December 15, 2005. In connection with the reorganization, (i) Howard Bank became our wholly-owned subsidiary, (ii) each outstanding share (or fraction thereof) of Howard Bank common stock was converted into two shares (or fraction thereof) of our common stock, and the former holders of Howard Bank common stock became the holders of all our outstanding shares, and (iii) warrants and options to purchase shares of Howard Bank common stock became options and warrants to purchase Howard Bancorp stock and were adjusted to reflect the exchange of two shares of our common stock for each share of the Bank's common stock.

We completed our initial public offering in July 2012, issuing 1,150,891 shares of our common stock. Simultaneously with our initial public offering we completed a private placement pursuant to which we sold 568,603 shares of our common stock.

The Company's primary business is owning all of the capital stock of Howard Bank. In addition to regulation of the Bank, as a bank holding company registered under the Bank Holding Company Act of 1956, we are subject to regulation and review by the Federal Reserve. See "— Supervision and Regulation."

Howard Bank

Howard Bank is a trust company chartered under Subtitle 2 of Title 3 of the Financial Institutions Article of the Annotated Code of Maryland. The Bank was formed in March 2004 and commenced banking operations on August 9, 2004. Howard Bank has chosen, for the time being, not to seek and exercise trust powers, and our business, powers and regulatory structure is the same as a Maryland-chartered commercial bank. The Bank is subject to regulation, supervision and regular examination by the Maryland Commissioner of Financial Regulation and the Federal Deposit Insurance Corporation ("FDIC"), and our deposits are insured by the FDIC. The Bank has four operating subsidiaries, three of which hold foreclosed real estate and the other of which owns and manages real estate that we use for one of our branch locations and that also contains office and retail space.

Howard Bank is headquartered in Ellicott City, which is located in Howard County, Maryland. It has branches in Howard County as well as in Anne Arundel County, Baltimore County, and Harford County in Maryland. We engage in a general commercial banking business, making various types of loans and accepting deposits. We market our financial services to small and medium sized businesses and their owners, professionals and executives, and high-net-worth individuals (the “mass affluent”).

Our core business strategy involves delivering advice and superior customer service to clients through local decision makers. We combine the Bank’s specialized focus on both local markets and small and medium-sized business related market segments with a broad array of products, new technology and seasoned banking professionals to position the Bank differently from most competitors. Our experienced executives establish a relationship with each client and bring value to all phases of a client’s business and personal banking needs. To develop this strategy, we have established long-standing relationships with key customers in the community and with local business leaders who can create business opportunities.

Our primary source of revenue is net interest income, with fees generated by lending, mortgage banking and depository service charges constituting a smaller share of revenues. We have positioned the balance sheet to hold a high percentage of earning assets and, in turn, to have those earning assets dominated by loans rather than securities investments. Generally speaking, loans earn more attractive returns than investments and are a key source of product cross sales and customer referrals. Certain economic conditions may favor investments over loans, such as poor corporate earnings, downturns in real estate cycles and other general slowing economic conditions. At all times, our loan and investment strategies seek to balance the need to maintain adequate liquidity via excess cash or federal funds sold with opportunities to appropriately leverage our capital.

Our strategic plan focuses on enhancing stockholder value through market share growth as reflected in balance sheet growth, related revenue growth and resulting growth in operating profits. We acquired our sixth full service branch location in Aberdeen, Maryland in the third quarter of 2013, opened our seventh branch location in Towson, Maryland in the fourth quarter of 2013 and plan to open an additional full service branch in Bel Air, Maryland in the first quarter of 2014. We plan to open additional branches in the counties where we now operate and contiguous counties over the next several years, although we have no definitive plans or agreements in place with respect to any such additional branches. Our long-term vision includes supplementing our historically organic growth with strategically significant acquisitions. We believe that acquiring other financial institutions - in whole or in part (through business line spin-offs, branch sales or the hiring of teams of individuals) will allow us to expand our market, achieve certain operating efficiencies, and grow our stockholder base and thus our share value and liquidity. We believe that our demonstrated expertise in commercial lending, deposit gathering (especially non-interest bearing transactional deposits) and community leadership positions us as an attractive acquirer. We also anticipate that increasing our capital levels will give us the ability to continue our organic asset growth and expand our relationships with key clients through a larger legal lending limit. Since the Bank’s opening in late 2004, we have participated loans and loan commitments to correspondent banking institutions because of our inability to retain 100% of certain loans originated given our legal lending limit.

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Our Market Area

Our headquarters are located in Ellicott City, Maryland, and we consider our primary market area to be the Greater Baltimore Metropolitan Area in Maryland. We also have loans outside our market areas, although we do not actively solicit business outside our primary market.

We have seven full services branches, four located throughout Howard County, one in Annapolis, one in Towson and one in Harford County.

Howard County	Anne Arundel	Baltimore	Harford
Snowden River	**Defense Highway**	**Towson**	**Aberdeen**
6011 University Blvd.	116 Defense Hwy.	22 W. Pennsylvania Ave.	3 West Bel Air Ave.
Suite 150	Annapolis, MD	Towson, MD	Aberdeen, MD 21001
Ellicott City, MD 21043			

Hickory Ridge

6430 Freetown Rd.

Columbia, MD 21044

Maple Lawn

10985 Johns Hopkins Rd.

Laurel, MD 20723

Centennial Place

10161 Baltimore National Pk.

Ellicott City, MD 21042

Competitive Position

We believe that our position as a community bank with nearly $500 million in assets positions us well to survive the current economic slowdown, market consolidation and heightened regulatory environment. Our formation in 2003 and 2004 has positioned us to take advantage of the ability to outsource certain activities (internal audit, compliance review, information security monitoring) and to source new products and services (check imaging, online banking) in a highly efficient manner and thus avoid the risk of impairment of operating earnings faced by some older small banks who, we believe, are locked into legacy systems and are finding the onslaught of new regulations challenging. Strategic partnerships for these outsourced activities include contractual relationships with some of the largest and strongest providers of item processing, data processing, information monitoring and payments systems alternatives. We believe that this provides the Bank with the best of technology and product selection without sacrificing the more intimate delivery advantages of a community bank. We believe the current economic and regulatory environment will lead to greater consolidation among financial institutions, including community banks. Some of that consolidation will occur with larger banks, thus exacerbating the scarcity of banks able to underwrite traditionally and offer advice in interactions with customers as we do, which we believe gives us a wider window of opportunity to extend our brand and value proposition. We believe, however, that to the extent some of that consolidation occurs between and among smaller banks, the resulting combined institutions will be better positioned to differentiate themselves.

We believe that our “Hands On” approach to delivering small and medium-sized businesses a very broad and deep array of competitive credit and cash management services through a term of experienced advisors and providing them with access to local policy and decision makers fills a “white space” between the sophisticated but distracted large banks whose best personnel work with the largest companies and the small banks who are very responsive but less capable of being proactive in providing advice. Relationship managers, team leaders and executive management at the Bank generally have decades of banking experiences and are well established in the communities that they serve. They are able to interface with clients directly to share that experience and to provide connections with their own network of other specialized advisors. We believe we also benefit from our committed leadership at both the executive management and board level who bring a broad array of skills and experiences to our company and are able to position the Bank for consistent profitable growth.

Lending Activities

General

Our primary market focus is on making loans to and gathering deposits from small and medium size businesses and their owners, professionals and executives, and high-net-worth individuals in our primary market area. Our loans are made to customers primarily in the Greater Baltimore market. Our lending activities consist generally of short to medium term commercial lending, commercial mortgage lending for both owner occupied and investor properties, residential mortgage lending and consumer lending, both secured and unsecured. A substantial portion of our loan portfolio consists of loans to businesses secured by real estate and/or other business assets.

Credit Policies and Administration

We have adopted a comprehensive lending policy, which includes stringent underwriting standards for all types of loans. Our lending teams follow pricing guidelines established periodically by our management team. In an effort to manage risk, only small lending authority is given to individual loan officers. Most loan officers can approve loans of up to $50,000. Regional Executives and the Senior Credit Officer can approve loans up to $250,000 and our President and Chief Executive Officer and our Chief Loan Officer can approve loans of up to $500,000, or $1,000,000 combined. Loans above these amounts but less than $2 million must be reviewed and approved by an officers' Loan Committee. All credit decisions in excess of the officers' Loan Committee lending authority must be approved prior to funding by our Board Loan Committee. Under the leadership of our executive management team, we believe that we employ experienced lending officers, secure appropriate collateral and carefully monitor the financial conditions of our borrowers and the concentration of loans in our portfolio.

In addition to the normal repayment risks, all loans in the portfolio are subject to the state of the economy and the related effects on the borrower and/or the real estate market. Generally, longer-term loans have periodic interest rate adjustments and/or call provisions. Senior management monitors the loan portfolio closely to ensure that we minimize past due loans and that we swiftly deal with potential problem loans.

Howard Bank also retains an outside, independent firm to review the loan portfolio. This firm performs a detailed annual review. We use the results of the firm's report primarily to validate the risk ratings applied to loans in the portfolio and identify any systemic weaknesses in underwriting, documentation or management of the portfolio. Results of the annual review are presented to executive management, the Audit Committee of the board and the full board of directors and are available to and used by regulatory examiners when they review the Bank's asset quality. We currently use the firm of Clifton Larsen Allen to perform this review.

The Bank maintains the normal checks and balances on the loan portfolio not only through the underwriting process but through the utilization of an internal credit administration group that both assists in the underwriting and serves as an additional reviewer of underwriting. The separately-managed loan administration group also has oversight for documentation, compliance and timeliness of collection activities. Our outsourced internal audit firm also reviews documentation, compliance and file management.

Commercial Lending

Our commercial lending consists of lines of credit, revolving credit facilities, accounts receivable and inventory financing, term loans, equipment loans, small business administration (SBA) loans, stand-by letters of credit and unsecured loans. We originate commercial loans for any business purpose, including the financing of leasehold improvements and equipment, the carrying of accounts receivable, general working capital, contract administration and acquisition activities. These loans typically have maturities of seven years or less. We have a diverse client base and we do not have a concentration of these types of loans in any specific industry segment. We generally secure commercial business loans with accounts receivable and inventory, equipment, indemnity deeds of trust and other collateral such as marketable securities, cash value of life insurance, and time deposits at Howard Bank. Commercial business loans have a higher degree of risk than residential mortgage loans because the availability of funds for repayment generally depends on the success of the business. To help manage this risk, we establish parameters/ covenants at the inception of the loan to provide early warning systems before payment default. We normally seek to obtain appropriate collateral and personal guarantees from the borrower's principal owners. We are able, given our business model, to proactively monitor the financial condition of the business.

Commercial Mortgage Lending

We finance commercial real estate for our clients, for both owner-occupied properties and investor properties (including residential properties). We generally will finance owner occupied commercial real estate at a maximum loan–to-value of 85% and non-owner occupied at a maximum loan-to-value of 80%. Our underwriting policies and processes focus on the underlying credit of the owner for owner occupied real estate and on the rental income stream (including rent terms and strength of tenants) for non-owner occupied real estate as well as an assessment of the underlying real estate. Risks inherent in managing a commercial real estate portfolio relate to vacancy rates/ absorption rates for surrounding properties, sudden or gradual drops in property values as well as changes in the economic climate. We attempt to mitigate these risks by carefully underwriting loans of this type as well as by following appropriate loan-to-value standards. We are cash flow lenders and never rely solely on property valuations in reaching a lending decision. Personal guarantees are often required for commercial real estate loans as they are for other commercial loans. Most of our real estate loans carry fixed interest rates, amortize over 20 – 25 years but have five- to seven-year maturities. Properties securing our commercial real estate loans primarily include office buildings, office condominiums, distribution facilities and manufacturing plants. Substantially all of our commercial real estate loans are secured by properties located in our market area.

Commercial real estate loans generally carry higher interest rates and have shorter terms than one- to four-family residential mortgage loans. Commercial real estate loans, however, entail significant additional risks as compared with residential mortgage lending, as they typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment of loans secured by income-producing properties typically depends on the successful operation of the property, as repayment of the loan generally is dependent, in large part, on sufficient income from the property to cover operating expenses and debt service. Changes in economic conditions that are not in the control of the borrower or lender could affect the value of the collateral for the loan or the future cash flow of the property. Additionally, any decline in real estate values may be more pronounced for commercial real estate than residential properties.

Construction Lending

Construction lending can cover funding for land acquisition, land development and/or construction of residential or commercial structures. Our construction loans generally bear a variable rate of interest and have terms of one to two years. Funds are advanced on a percentage-of-completion basis. These loans are generally repaid at the end of the development or construction phase, although loans for commercial construction will often convert into a permanent commercial mortgage loans at the end of the term of the loan. Loan to value parameters range from 65% of the value of land to 75% for developed land, 80% for commercial or multifamily construction and 85% for residential construction. These loan-to-value ratios represent the upper limit of advance rates to remain in compliance with Bank policy. Typically, loan-to-value ratios should be somewhat lower than these upper limits, requiring the borrower to provide significant equity at the inception of the loan. Our underwriting looks not only at the value of the property but the expected cash flows to be generated by sale of the parcels or completed construction. The borrower must have solid experience in this type of construction and personal guarantees are usually required.

Construction lending entails significant risks compared with residential mortgage lending. These risks involve larger loan balances concentrated with single borrowers with funds advanced upon the security of the land or the project under construction. The value of the project is estimated prior to the completion of construction. Thus, it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan to value ratios. If the estimate of construction or development cost proves to be inaccurate, we may be required to advance additional funds beyond the amount originally committed in order to protect the value of the property. Moreover, if the estimated value of the completed project proves to be inaccurate, the borrower may hold a property with a value that is insufficient to assure full repayment. To mitigate these risks, in addition to the underwriting considerations noted above, we maintain an in-house construction monitoring unit that has oversight for the projects and we require both site visits and frequent reporting before funds are advanced.

Residential Mortgage Lending

We offer a variety of consumer-oriented residential real estate loans. Residential mortgage loans consist primarily of first mortgage loans to individuals, most of which have a loan to value not exceeding 85%. The remainder of this portion of our portfolio consists of home equity lines of credit and fixed rate home equity loans.

Our residential mortgage loans are generally for owner-occupied single family homes. These loans are generally for a primary residence although we will occasionally originate loans for a second home where the borrower has extremely strong credit. Our residential mortgage loans are generally fixed rate loans with 15- or 30-year terms. We will also originate variable rate loans with a five- to seven-year term, although such loans have a longer amortization schedule.

Our home equity loans and home equity lines of credit are primarily secured by a second mortgage on owner occupied one-to four-family residences. Our home equity loans are originated at fixed interest rates and with terms of between five and 30 years for primary residences and between five and 15 years for secondary and rental properties, and are fully amortizing. Our home equity lines allow for the borrower to draw against the line for ten years, after which the line is refinanced into a ten-year fixed loan, with the possibility of a one-time extension of five years. Home equity lines of credit carry a variable rate of interest and minimum monthly payments during the draw period, which are the greater of (i) $50.00 or (ii) depending on credit score, loan-to-value and debt-to-income ratios, either the interest due or interest due plus 1% of the outstanding loan balance. Home equity loans and lines of credit are generally underwritten with a maximum loan-to-value ratio of 85% (80% when appraised value is greater than $1 million) for a primary residence when combined with the principal balance of the existing mortgage loan; for home equity loans on secondary and rental properties, the maximum loan-to-value ratio is 65%. We require appraisals on all real estate loans – both commercial and residential. At the time we close a home equity loan or line of credit, we record a mortgage to perfect our security interest in the underlying collateral. Home equity loans and lines of credit also require title insurance, and borrowers must obtain hazard insurance, and if applicable, flood insurance.

Home equity loans and lines of credit generally have greater risk than one- to four-family residential mortgage loans. In these cases, we face the risk that collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. In particular, because home equity loans are secured by second mortgages, decreases in real estate values could adversely affect the value of the property serving as collateral for these loans. Thus, the recovery of such property could be insufficient to compensate us for the value of these loans.

Loans secured by second mortgages have greater risk than owner-occupied residential loans secured by first mortgages. When customers default on their loans we attempt to foreclose on the property. However, the value of the collateral may not be sufficient to compensate for the amount of the unpaid loan, and we may be unsuccessful in recovering the remaining balance from these customers. In addition, decreases in property values could adversely affect the value of properties used as collateral for the loans. These second lien loans represent a smaller portion of our portfolio.

Our home equity and home improvement loan portfolio gives us a diverse client base. Although most of these loans are in our primary market area, the diversity of the individual loans in the portfolio reduces our potential risk.

Consumer Lending

We offer various types of secured and unsecured consumer loans. Generally, our consumer loans are made for personal, family or household purposes as a convenience to our customer base. As a general guideline, a consumer's total debt service should not exceed 40% of their gross income. The underwriting standards for consumer loans include a determination of the applicant's payment history on other debts and an assessment of his or her ability to meet existing obligations and payments on the proposed loan.

Consumer loans may present greater credit risk than residential mortgage loans because many consumer loans are unsecured or are secured by rapidly depreciating assets. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance because of the greater likelihood of damage, loss or depreciation. Consumer loan collections also depend on the borrower's continuing financial stability. If a borrower suffers personal financial difficulties, the loan may not be repaid. Also, various federal and state laws, including bankruptcy and insolvency laws, may limit the amount we can recover on such loans.

Loan Originations, Purchases, Sales, Participations and Servicing

All loans that we originate are underwritten pursuant to our policies and procedures, which incorporate standard underwriting guidelines. We originate both fixed and variable rate loans. Our loan origination activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand. We generally retain in our portfolio the majority of loans that we originate, except for first lien residential mortgage loans where we sell the majority of the loans into the secondary market. We do not retain the servicing rights on sold loans.

We occasionally sell participations in commercial loans to correspondent banks if the amount of the loan exceeds our internal limits. More rarely, we purchase loan participations from correspondent banks in the local market as well. Those loans are underwritten in- house with the same care of loans directly originated.

Loan Approval Procedures and Authority

Our lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by our board of directors. The loan approval process is intended to assess the borrower’s ability to repay the loan, the viability of the loan, and the adequacy of the value of the collateral that will secure the loan, if applicable. To assess a business borrower’s ability to repay, we review and analyze, among other factors: current income, credit history including the Bank’s prior experience with the borrower, cash flow, any secondary sources of repayment, other debt obligations in regards to the equity/net worth of the borrower and collateral available to the Bank to secure the loan.

We require appraisals of all real property securing one- to four-family residential and commercial real estate loans and home equity loans and lines of credit. All appraisers are state-licensed or state-certified appraisers, and our practice is to have local appraisers approved by the board of directors annually.

Investments and Funding

We balance our liquidity needs based on loan and deposit growth via the investment portfolio and short term borrowings. It is our goal to provide adequate liquidity to support our loan growth. We use the generally short term investments that represent our liquidity to generate additional positive earnings. Howard Bank's primary source of funds is, and will continue to be, core deposits generated from the local marketplace. Additional funding is provided by customer repurchase agreements, Federal Home Loan Bank ("FHLB") advances, the Board of Governors of the Federal Reserve (the "FRB") Discount Window, and other purchased funds. Other purchased funds may include certificates of deposit over $100,000, federal funds purchased, and institutional or brokered deposits. Lines of credit with the FHLB of Atlanta are maintained to protect liquidity levels resulting from unexpected deposit withdrawals and natural-market credit demand.

Our investment policy is reviewed annually by our board of directors. The board of directors has appointed its Executive Committee to serve as the Investment Committee, and the Executive Committee therefore meets at regular intervals (not less than quarterly) and provides a report on the investment portfolio performance to the full board of directors. The investment officer is designated by the President and is responsible for managing the day-to-day activities of the liquidity and investments in accordance with the policies approved by the board of directors. The investment officer is presently our Chief Financial Officer. We actively monitor our investment portfolio and we classify the majority of the portfolio as "available for sale." In general, under such a classification, we may sell investment instruments as management deems appropriate.

Other Banking Products

We offer our customers wire transfer services, courier service for non-negotiable deposits, ATM and check cards, automated teller machines at all of our full-service branch locations, safe deposit boxes at all full service locations and credit cards through a third party processor. Additionally, we provide Internet banking capabilities to our customers and merchant card services for our business customers. With our Internet banking service, our customers may view their accounts on line and electronically remit bill payments. Our commercial account services include an overnight sweep service and remote deposit capture service.

We complement our existing Internet and eBanking services with Mobiliti Mobile Banking, PopMoney and eStatement products. These state of the art products provide the Bank's consumer customers the ability to view account information and pay bills from their mobile device, easily make payments directly to individuals and, with eStatements, to replace their paper monthly statement with an electronically delivered statement.

Deposit Activities

Deposits are the major source of our funding. We offer a broad array of consumer and business deposit products that include demand, money market, savings and individual retirement accounts, as well as certificates of deposit. We offer through key technology partnerships a competitive array of commercial cash management products, which in combination with our in-house courier service and remote deposit/ check imaging service, allow us to attract demand deposits. We believe that we pay competitive rates on our interest bearing deposits. As a relationship-oriented organization, we generally seek to obtain deposit relationships with our loan clients.

We also use customer repurchase agreements, FHLB advances, the FRB Discount Window and other purchased funds as a funding mechanism. Other purchased funds may include certificates of deposits over $100,000, federal funds purchased and institutional or brokered deposits.

Employees

Howard Bank has 98 full-time employees and four part-time employees as of December 31, 2013. None of our employees are represented by any collective bargaining unit, and we believe that relations with our employees are good. Howard Bancorp has no employees.

Lending Limit

The Bank’s legal lending limit for loans to one borrower was approximately $7.1 million as of December 31, 2013. We further monitor our exposure to one borrower through a policy to limit our “in-house” lending limit to $6.0 million, which in-house limit can be waived by our board Loan Committee. As part of our risk management strategy, we may attempt to participate a portion of larger loans to other financial institutions. This strategy allows us to maintain customer relationships yet observe the legal lending limit and manage credit exposure. However, this strategy may not always be available.

Competition

Our primary market area is highly competitive and heavily branched by other financial institutions of all sizes. Competition for loans to small and medium sized businesses and their owners, professionals and executives, and high-net-worth individuals is intense, and pricing is important. We believe that acquisitions of several local competitors by larger institutions headquartered outside of the State of Maryland during the last several years have enhanced the Bank’s positioning as a locally headquartered and managed community bank, but many of these competitors now have substantially greater resources and lending limits than we do and offer services, such as extensive and established branch networks and trust services, that we do not expect to provide in the near future or ever. Moreover, larger institutions operating in our primary market area may have access to borrowed funds at a lower rate than is available to us. Deposit competition is also strong among institutions in our primary market area.

However, recent mergers of other area banks into large regional and national financial institutions have created opportunities for community-focused and prudently managed community banks. While our board of directors is aware of the competition that these larger institutions offer, we believe that local independent banks play and will continue to play a significant role in our primary market area. Our board of directors believes it is a significant and distinct advantage to be a community owned and operated state bank interested in serving the needs of small and medium sized businesses and their owners, professionals and executives, and high-net-worth individuals.

Participation in Small Business Lending Fund

On September 22, 2011, we entered into a securities purchase agreement with the Secretary of the Treasury pursuant to which we sold to the Secretary of the Treasury 12,562 shares of our Series AA Preferred Stock, having a liquidation amount per share equal to $1,000, for an aggregate purchase price of $12,562,000. We issued the Series AA Preferred Stock pursuant to Treasury’s Small Business Lending Fund (“SBLF”). Enacted into law as part of the Small Business Jobs Act of 2010, the SBLF was a $30 billion fund designed to encourage lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than $10 billion at favorable rates. We are pleased to be one of only four banks in the State of Maryland that was approved to participate in this program. The Series AA Preferred Stock qualifies as Tier 1 capital and is generally non-voting. In accordance with the terms of the SBLF program, the Series AA Preferred Stock has an initial annual dividend rate of 5%. The dividend rate will be reduced if our small business lending increases by at least 2.5%; this reduced rate may be as low as 1% if such lending increases by 10% or more. If we increase small business lending by at least 2.5% but by less than 10%, the rate on the Series AA Preferred Stock may fall to between 2% and 4%, but if lending does not increase in the first two and one-half years the annual dividend rate will increase to 7%. After four and one-half years, the dividend rate will increase to 9% if we have not repaid the SBLF funding at such time.

SUPERVISION AND REGULATION

Howard Bancorp, Inc.

We are a bank holding company under the Bank Holding Company Act of 1956, as amended. We are subject to regulation and examination by the FRB, and are required to file periodic reports and any additional information that the FRB may require. The Bank Holding Company Act generally prohibits a bank holding company from engaging in activities other than banking, managing or controlling banks or other permissible subsidiaries, and acquiring or retaining direct or indirect control of any company engaged in any activities closely related to banking or managing or controlling banks.

The status of Howard Bancorp, Inc. as a registered bank holding company under the Bank Holding Company Act and a Maryland-chartered bank holding company does not exempt it from certain federal and state laws and regulations applicable to corporations generally, including, without limitation, certain provisions of the federal securities laws.

Howard Bank

Howard Bank is a Maryland chartered trust company (with all powers of a commercial bank), and its deposit accounts are insured by the Deposit Insurance Fund ("DIF") of the FDIC up to the maximum legal limits. It is subject to regulation, supervision and regular examination by the Maryland Commissioner of Financial Regulation and the FDIC. The regulations of these various agencies govern most aspects of Howard Bank's business, including required reserves against deposits, loans, investments, mergers and acquisitions, borrowing, dividends and location and number of branch offices. The laws and regulations governing Howard Bank generally have been promulgated to protect depositors and the DIF, and not for the purpose of protecting stockholders.

Set forth below is a brief description of the material regulatory requirements that are or will be applicable to Howard Bank and Howard Bancorp, Inc. The description below is limited to the material aspects of the statutes and regulations addressed, and is not intended to be a complete description of such statutes and regulations and their effects on Howard Bank and Howard Bancorp, Inc.

Banking Regulation

Financial Institutions Article of the Maryland Annotated Code

The Financial Institutions Article of the Maryland Annotated Code (the “Banking Code”) contains detailed provisions governing the organization, operations, corporate powers, commercial and investment authority, branching rights and responsibilities of directors, officers and employees of Maryland banking institutions. The Banking Code delegates extensive rulemaking power and administrative discretion to the Maryland Office of the Commissioner of Financial Regulation in its supervision and regulation of state-chartered banking institutions. The Maryland Office of the Commissioner of Financial Regulation may order any banking institution to discontinue any violation of law or unsafe or unsound business practice.

Capital Requirements

Under the FDIC’s regulations, federally insured state-chartered banks that are not members of the Federal Reserve System (“state non-member banks”), such as Howard Bank, are required to comply with minimum leverage capital requirements. For an institution determined by the FDIC to not be anticipating or experiencing significant growth and to be, in general, a strong banking organization rated composite 1 under Uniform Financial Institutions Ranking System established by the Federal Financial Institutions Examination Council, the minimum capital leverage requirement is a ratio of Tier 1 capital to total assets of 3.0%. For all other institutions, the minimum leverage capital ratio is not less than 4.0%. Tier 1 capital is the sum of common stockholders’ equity, noncumulative perpetual preferred stock (including any related surplus) and minority investments in certain subsidiaries, less intangible assets (except for certain servicing rights and credit card relationships) and certain other specified items.

In addition, FDIC regulations require state non-member banks to maintain certain ratios of regulatory capital to regulatory risk-weighted assets, or “risk-based capital ratios.” Risk-based capital ratios are determined by allocating assets and specified off-balance sheet items to four risk-weighted categories ranging from 0.0% to 200.0%. State non-member banks must maintain a minimum ratio of total capital to risk-weighted assets of at least 8.0%, of which at least one-half must be Tier 1 capital. Total capital consists of Tier 1 capital plus Tier 2 or supplementary capital items, which include allowances for loan losses in an amount of up to 1.25% of risk-weighted assets, cumulative preferred stock and certain other capital instruments, and a portion of the net unrealized gain on equity securities. The includable amount of Tier 2 capital cannot exceed the amount of the institution’s Tier 1 capital.

At this time the bank regulatory agencies are more inclined to impose higher capital requirements in order to meet well capitalized standards, and future regulatory change could impose higher capital standards as a routine matter. The regulators may also set higher capital requirements for holding companies whose circumstances warrant it. For example, holding companies experiencing internal growth or making acquisitions are expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

As an additional means to identify problems in the financial management of depository institutions, the Federal Deposit Insurance Act requires federal bank regulatory agencies to establish certain non-capital safety and soundness standards for institutions for which they are the primary federal regulator. The standards relate generally to operations and management, asset quality, interest rate exposure and executive compensation. The agencies are authorized to take action against institutions that fail to meet such standards.

Prompt Corrective Action

Under federal prompt corrective action regulations, the FDIC is authorized and, under certain circumstances required, to take supervisory actions against state non-member banks that are not adequately capitalized. Under these regulations, a bank is considered to be (i) ‘‘well capitalized’’ if it has total risk-based capital of 10.0% or more, Tier 1 risk-based capital of 6.0% or more, Tier 1 leverage capital of 5.0% or more, and is not subject to any written capital order or directive; (ii) ‘‘adequately capitalized’’ if it has total risk-based capital of 8.0% or more, Tier 1 risk-based capital of 4.0% or more and Tier 1 leverage capital of 4.0% or more (3.0% under certain circumstances), and does not meet the definition of ‘‘well capitalized’’; (iii) ‘‘undercapitalized’’ if it has total risk-based capital of less than 8.0%, Tier 1 risk-based capital of less than 4.0% or Tier 1 leverage capital of less than 4.0% (3.0% under certain circumstances); (iv) ‘‘significantly undercapitalized’’ if it has total risk-based capital of less than 6.0%, Tier 1 risk-based capital less than 3.0%, or Tier 1 leverage capital of less than 3.0%; and (v) ‘‘critically undercapitalized’’ if its ratio of tangible equity to total assets is equal to or less than 2.0%. Under certain circumstances, that FDIC may reclassify a well capitalized institution as adequately capitalized, and may require an adequately capitalized institution or an undercapitalized institution to comply with supervisory actions as if it were in the next lower category (except that the FDIC may not reclassify a significantly undercapitalized institution as critically undercapitalized). As of December 31, 2012, Howard Bank was ‘‘well capitalized’’ for this purpose.

Howard Bank has been ‘‘well capitalized’’ since it commenced its business operations.

New Capital Rules

In July 2013, the FDIC and other federal bank regulatory agencies approved revisions to their capital adequacy guidelines and prompt corrective action rules that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. The rules include new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes “capital” for calculating those ratios. The proposed new minimum capital level requirements applicable to Howard Bank will be: (1) a new common equity Tier 1 capital ratio of 4.5%; (2) a Tier 1 capital ratio of 6% (increased from 4%); (3) a total capital ratio of 8% (unchanged from current rules); and (4) a Tier 1 leverage ratio of 4%. The rules assign different risk weights to some assets, including a higher risk weight (150%) to exposures that are more than 90 days past due or are on non-accrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The new capital conservation buffer requirement will be phased in beginning in January 2016 until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses to executive officers if its capital level falls below the buffer amount.

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The ultimate impact of the new capital and liquidity standards on our operations is currently being reviewed and will depend on a number of factors. We cannot determine the ultimate effect that the new requirements will have upon our earnings or financial position, although the requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact our financial results.

Dividends

Howard Bancorp, Inc. is a legal entity separate and distinct from Howard Bank. Virtually all of Howard Bancorp's revenue available for the payment of dividends on its common stock results from dividends paid to Howard Bancorp by Howard Bank. Under Maryland law, Howard Bank may declare a cash dividend, after providing for due or accrued expenses, losses, interest and taxes, from its undivided profits or, with the prior approval of the Maryland Office of the Commissioner of Financial Regulation, from its surplus in excess of 100% of its required capital stock. Also, if Howard Bank's surplus is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, the bank regulatory agencies have the ability to prohibit or limit proposed dividends if such regulatory agencies determine the payment of such dividends would result in Howard Bank being in an unsafe and unsound condition.

Deposit Insurance Assessments

Howard Bank's deposit accounts are insured by the FDIC generally up to a maximum of $250,000 per separately insured depositor. FDIC-insured depository institutions are required to pay deposit insurance assessments to the FDIC. The amount of a particular institution's deposit insurance assessment is based on that institution's risk classification under an FDIC risk-based assessment system. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators. Deposit insurance assessments fund the DIF, which is currently under-funded.

The Dodd-Frank Act changed the way an insured depository institution's deposit insurance premiums are calculated. The assessment base will no longer be the institution's deposit base, but rather its average consolidated total assets less its average tangible equity. The legislation also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008. The Dodd-Frank Act also made changes to the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% percent to 1.35% of the estimated amount of total insured deposits, eliminating the upper limit for the reserve ratio designated by the FDIC each year, and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds.

As mandated by the Dodd-Frank Act, in February 2011, the FDIC approved a final rule that changes the deposit insurance assessment system from one that is based on domestic deposits to one that is based on average consolidated total assets minus average tangible equity. In addition, the rule adopts a ‘‘scorecard’’ assessment scheme for larger banks and suspends dividend payments indefinitely if the DIF reserve ratio exceeds 1.5% percent, but provides for decreasing assessment rates when the reserve ratio reaches certain thresholds. Under the new rule, larger insured depository institutions will likely be forced to pay higher assessments than under the old system, which should offset the cost of the assessment increases for institutions with consolidated assets of less than $10 billion, such as Howard Bank.

Maryland Regulatory Assessment

The Maryland Office of the Commissioner of Financial Regulation annually assesses state banking institutions to cover the expense of regulating banking institutions. The Bank's asset size determines the amount of the assessment.

Liquidity

Howard Bank is subject to the reserve requirements imposed by the State of Maryland. A Maryland banking institution is required to have at all times a reserve equal to at least 15% of its demand deposits. Howard Bank is also subject to the uniform reserve requirements of the FRB's Regulation D, which applies to all depository institutions with transaction accounts or non-personal time deposits. For 2013, amounts in transaction accounts above $12.4 million and up to $79.5 million must have reserves held against them in the ratio of three percent of the amount. Amounts above $79.5 million require reserves of $2,013,000 plus 10 percent of the amount in excess of $79.5 million. For 2014, amounts in transaction accounts above $13.3 million and up to $89.0 million must have reserves held against them in the ratio of three percent of the amount. Amounts above $89.0 million require reserves of $2,271,000 plus 10 percent of the amount in excess of $89.0 million. The Maryland reserve requirements may be used to satisfy the requirements of Regulation D. Howard Bank is in compliance with its reserve requirements.

Loans-to-One-Borrower Limitation

With certain limited exceptions, a Maryland banking institution may lend to a single or related group of borrowers an amount equal to 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if such loan is secured by readily marketable collateral, which is defined to include certain securities and bullion, but generally does not include real estate. Howard Bank is in compliance with the loans-to-one borrower limitations.

Community Reinvestment Act and Fair Lending Laws

Under the Community Reinvestment Act of 1977 ("CRA"), the FDIC is required to assess the record of all financial institutions regulated by it to determine if such institutions are meeting the credit needs of the community (including low and moderate income neighborhoods) which they serve. CRA performance evaluations are based on a four-tiered rating system: Outstanding, Satisfactory, Needs to Improve and Substantial Noncompliance. CRA performance evaluations are considered in evaluating applications for such things as mergers, acquisitions and applications to open branches. Howard Bank has a CRA rating of "Outstanding." In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the FDIC, the Department of Housing and Urban Development, and the Department of Justice, and in private civil actions by borrowers.

Transactions with Related Parties

Transactions between banks and their related parties or affiliates are limited by Sections 23A and 23B of the Federal Reserve Act. An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the bank. In a holding company context, the parent bank holding company and any companies which are controlled by such parent holding company are affiliates of the bank.

Generally, Section 23A of the Federal Reserve Act and the FRB's Regulation W limit the extent to which a bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10.0% of such bank's capital stock and surplus, and contain an aggregate limit on all such transactions with all affiliates to an amount equal to 20.0% of such bank's capital stock and surplus. The term ''covered transaction'' includes the making of loans, purchase of assets, issuance of guarantees and other similar transactions. In addition, loans or other extensions of credit by the bank to an affiliate are required to be collateralized in accordance with regulatory requirements and the bank's transactions with affiliates must be consistent with safe and sound banking practices and may not involve the purchase by the bank of any low-quality asset. Section 23B applies to covered transactions as well as certain other transactions and requires that all such transactions be on terms substantially the same, or at least as favorable, to the institution or subsidiary as those provided to non-affiliates.

Section 22(h) of the Federal Reserve Act and the FRB's Regulation O govern extensions of credit made by a bank to its directors, executive officers, and principal stockholders (''insiders''). Among other things, these provisions require that extensions of credit to insiders be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features. Further, such extensions may not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Howard Bank's capital. Extensions of credit in excess of certain limits must also be approved by the board of directors.

Standards for Safety and Soundness

Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. Interagency guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to implement an acceptable compliance plan. Failure to implement such a plan can result in further enforcement action, including the issuance of a "cease and desist" order or the imposition of civil money penalties.

Anti-Money Laundering and OFAC

Under federal law, financial institutions must maintain anti-money laundering programs that include established internal policies, procedures and controls; a designated compliance officer; an ongoing employee training program; and testing of the program by an independent audit function. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must meet enhanced standards for due diligence and customer identification in their dealings with foreign financial institutions and foreign customers. Financial institutions must take reasonable steps to conduct enhanced scrutiny of account relationships to guard against money laundering and to report any suspicious transactions, and law enforcement authorities have been granted increased access to financial information maintained by financial institutions. Bank regulators routinely examine institutions for compliance with these obligations, and they must consider an institution's compliance in connection with the regulatory review of applications, including applications for banking mergers and acquisitions. The regulatory authorities have imposed "cease and desist" orders and civil money penalty sanctions against institutions found to be violating these obligations.

The Office of Foreign Assets Control, ("OFAC") is responsible for helping to insure that U.S. entities do not engage in transactions with certain prohibited parties, as defined by various Executive Orders and Acts of Congress. OFAC sends bank regulatory agencies lists of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, known as Specially Designated Nationals and Blocked Persons. If Howard Bancorp or Howard Bank finds a name on any transaction, account or wire transfer that is on an OFAC list, Howard Bancorp or Howard Bank must freeze such account, file a suspicious activity report and notify the appropriate authorities.

Consumer Protection Laws

Howard Bank is subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy. These laws include the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Fair and Accurate Credit Transactions Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, and the Real Estate Settlement Procedures Act, and various state law counterparts.

In addition, federal law currently contains extensive customer privacy protection provisions. Under these provisions, a financial institution must provide to its customers, at the inception of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These provisions also provide that, except for certain limited exceptions, a financial institution may not provide such personal information to unaffiliated third parties unless the institution discloses to the customer that such information may be so provided and the customer is given the opportunity to opt out of such disclosure. Further, under the ''Interagency Guidelines Establishing Information Security Standards,'' banks must implement a comprehensive information security program that includes administrative, technical, and physical safeguards to ensure the security and confidentiality of customer information. Federal law makes it a criminal offense, except in limited circumstances, to obtain or attempt to obtain customer information of a financial nature by fraudulent or deceptive means.

The Dodd-Frank Act

The Dodd-Frank Act, enacted in July 2010, will have a broad impact on the financial services industry, imposing significant regulatory and compliance changes, including the designation of certain financial companies as systemically significant, the imposition of increased capital, leverage, and liquidity requirements, and numerous other provisions designed to improve supervision and oversight of, and strengthen safety and soundness within, the financial services sector.

The following items provide a brief description of certain provisions of the Dodd-Frank Act.

- Source of strength. The Dodd-Frank Act requires all companies, including bank holding companies, that directly or indirectly control an insured depository institution to serve as a source of strength for the institution. Under this requirement, Howard Bancorp in the future could be required to provide financial assistance to Howard Bank should

Howard Bank experience financial distress.

- Mortgage loan origination and risk retention. The Dodd-Frank Act contains additional regulatory requirements that may affect our operations and result in increased compliance costs. For example, the Dodd-Frank Act imposes new standards for mortgage loan originations on all lenders, including banks, in an effort to require steps to verify a borrower's ability to repay. In addition, the Dodd-Frank Act generally requires lenders or securitizers to retain an economic interest in the credit risk relating to loans the lender sells or mortgage and other asset-backed securities that the securitizer issues. The risk retention requirement generally will be 5%, but could be increased or decreased by regulation.
- Consumer Financial Protection Bureau ("CFPB"). The Dodd-Frank Act created a new independent CFPB within the FRB. The CFPB is tasked with establishing and implementing rules and regulations under certain federal consumer protection laws with respect to the conduct of providers of certain consumer financial products and services. The CFPB has rulemaking authority over many of the statutes governing products and services offered to bank consumers. For banking organizations with assets under $10 billion, like Howard Bank, the CFPB has exclusive rule making authority, but the FDIC, as Howard Bank's primary federal regulator, would continue to have enforcement authority under federal consumer financial law. In addition, the Dodd-Frank Act permits states to adopt consumer protection laws and regulations that are stricter than those regulations promulgated by the CFPB. Compliance with any such new regulations would increase our cost of operations.
- Deposit insurance. The Dodd-Frank Act permanently increased the deposit insurance limit to $250,000 for insured deposits. Amendments to the Federal Deposit Insurance Act also revise the assessment base against which an insured depository institution's deposit insurance premiums paid to DIF will be calculated. Several of these provisions could increase the FDIC deposit insurance premiums paid by Howard Bank.

- Enhanced lending limits. The Dodd-Frank Act strengthened the limits on a depository institution's credit exposure to one borrower. Federal banking law limits a depository institution's ability to extend credit to one person (or group of related persons) in an amount exceeding certain thresholds. The Dodd-Frank Act expanded the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.
- Corporate governance. The Dodd-Frank Act addressed many investor protection, corporate governance and executive compensation matters that will affect most U.S. publicly traded companies, including Howard Bancorp. The Dodd-Frank Act provides the U.S. Securities Exchange Commission ("SEC') with authority to adopt proxy access rules that would allow stockholders of publicly traded companies to nominate candidates for election as a director and have those nominees included in a company's proxy materials and direct the SEC and national securities exchanges to adopt rules that; (1) provide stockholders of U.S. publicly traded companies an advisory vote on executive compensation; (2) will enhance independence requirements for compensation committee members; and (3) will require companies listed on national securities exchanges to adopt incentive-based compensation clawback policies for executive officers.

Some of the requirements of the Dodd-Frank Act have been implemented, while others will be implemented over time and most will be subject to regulations implemented over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements. Failure to comply with the new requirements may negatively impact our results of operations and financial condition. While we cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, these changes could be materially adverse to our investors.

Effect of Governmental Monetary Policies

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The FRB's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The monetary policies of the FRB affect the levels of bank loans, investments and deposits through its control over the issuance of United States government securities, its regulation of the discount rate applicable to member banks and its influence over reserve requirements to which member banks are subject. We cannot predict the nature or impact of future changes in monetary and fiscal policies.

<u>Bank Holding Company Regulation</u>

As a bank holding company, Howard Bancorp, Inc. is subject to regulation and examination by the Maryland Office of the Commissioner of Financial Regulation and the FRB. Howard Bancorp, Inc. is required to file with the FRB annual reports and such additional information as the FRB may require pursuant to the Bank Holding Company Act of 1956, as amended (the "BHC Act"). Among other things, the BHC Act requires regulatory filings by a stockholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution. The determination whether an investor "controls" a depository institution is based on all of the facts and circumstances surrounding the investment. As a general matter, a party is deemed to control a depository institution or other company if the party owns or controls 25% or more of any class of voting stock. Subject to rebuttal, a party may be presumed to control a depository institution or other company if the investor owns or controls 10% or more of any class of voting stock. Ownership by affiliated parties, or parties acting in concert, is typically aggregated for these purposes. If a party's ownership of Howard Bancorp were to exceed certain thresholds, the investor could be deemed to "control" Howard Bancorp for regulatory purposes. This could subject the investor to regulatory filings or other regulatory consequences.

Pursuant to provisions of the BHC Act and regulations promulgated by the FRB thereunder, Howard Bancorp, Inc. may only engage in or own companies that engage in activities deemed by the FRB to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto, and the holding company must obtain permission from the FRB prior to engaging in most new business activities. In addition, bank holding companies like Howard Bancorp must be well capitalized and well managed in order to engage in the expanded financial activities permissible only for a financial holding company.

Federal banking regulators have adopted risk-based capital guidelines for bank holding companies. Currently, the required minimum ratio of total capital to risk-weighted assets (including off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common stockholders' equity, non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock and minority interests in the equity accounts of consolidated subsidiaries, less goodwill. The remainder (Tier 2 capital) may consist of a limited amount of subordinated debt and intermediate-term preferred stock, certain hybrid capital instruments and other debt securities, perpetual preferred stock and a limited amount of the general loan loss allowance.

In addition to the risk-based capital guidelines, the federal banking regulators established minimum leverage ratio (Tier 1 capital to total assets) guidelines for bank holding companies. These guidelines provide for a minimum leverage ratio of 3% for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a leverage ratio of at least 4%.

The above risk-based and leverage ratio guidelines apply on a consolidated basis to any bank holding company with consolidated assets of $500 million or more. These guidelines also apply on a consolidated basis to any bank holding company with consolidated assets of less than $500 million if such holding company (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities or (iii) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC. As of December 31, 2013, Howard Bancorp, Inc. had consolidated assets of less than $500 million and did not satisfy the nonbanking, off-balance sheet, or debt requirements that would make it subject to the risk-based or leverage ratio requirements discussed above. However, under the Dodd-Frank Act and the FRB's Policy for Small Holding Companies it must continue to serve as a source of strength for its subsidiary bank.

The FRB has issued a policy statement regarding the payment of dividends by bank holding companies. In general, the FRB's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the bank holding company appears consistent with the organization's capital needs, asset quality, and overall financial condition. The FRB's policies also require that a bank holding company serve as a source of financial strength to its subsidiary banks by standing ready to use available resources to provide adequate capital funds to those banks during periods of financial stress or adversity and by maintaining the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks where necessary. Under the prompt corrective action laws, the ability of a bank holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect the ability of Howard Bancorp, Inc. to pay dividends or otherwise engage in capital distributions.

Federal and State Securities Laws

Our common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (the "Exchange Act"). As such, we are subject to the information, proxy solicitation, insider trading restrictions and other requirements of the Exchange Act.

Further, if we wish to sell common stock or other securities to raise capital in the future, we will be subject to the registration, anti-fraud, and other applicable provisions of state and federal securities laws. For example, we will have to register the sales of such securities under the Securities Act, the Maryland Securities Act, and the applicable securities laws of each state in which we offer or sell the securities, unless an applicable exemption from registration exists with respect to such sales. Such exemptions may, among other things, limit the number and types of persons we could sell such securities to and the manner in which we could market the securities. We would also be subject to federal and state anti-fraud requirements with respect to any statements we make to potential purchasers in connection with the offer and sale of such securities.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. As directed by the Sarbanes-Oxley Act, our Chief Executive Officer and Chief Financial Officer are be required to certify that our quarterly and annual reports do not contain any untrue statement of a material fact. The rules adopted by the Securities and Exchange Commission under the Sarbanes-Oxley Act have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of our internal control over financial reporting; they have made certain disclosures to our auditors and the Audit Committee of the board of directors about our internal control over financial reporting; and they have included information in our quarterly and annual reports about their evaluation and whether there have been changes in our internal control over financial reporting or in other factors that could materially affect internal control over financial reporting. We are subject to further reporting and audit requirements under the requirements of the Sarbanes-Oxley Act. We are also required to prepare policies, procedures and systems designed to ensure compliance with these regulations.

Item 1A. Risk Factors

You should consider carefully the following risks, along with the other information contained in and incorporated into this annual report. The risks and uncertainties described below are not the only ones that may affect us. Additional risks and uncertainties also may adversely affect our business and operations. If any of the following events actually occur, our business and financial results could be materially adversely affected.

A continuation or worsening of economic conditions could adversely affect our results of operations and financial condition.

Although the U.S. economy has emerged from the severe recession that occurred in 2008 and 2009, economic growth has been slow and inconsistent, and unemployment levels remain high. Recovery by many businesses has been impaired by lower consumer spending, and the ongoing lack of certainty in the economy continues to affect the willingness of companies to borrow to fund their future growth and otherwise decrease loan demand, which negatively impacts our business. A return to prolonged deteriorating economic conditions could significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. Further declines in sales volumes and continued elevated unemployment levels may result in higher than expected loan delinquencies, increases in our nonperforming and criticized classified assets and a decline in demand for our products and services. These events may cause us to incur losses and may adversely affect our financial condition and results of operations.

Because our loan portfolio consists largely of commercial business and commercial real estate loans, our portfolio carries a higher degree of risk than would a portfolio composed primarily of residential mortgage loans.

Our loan portfolio is made up largely of commercial business loans and commercial real estate loans, most of which is collateralized by real estate. These types of loans generally expose a lender to a higher degree of credit risk of non-payment and loss than do residential mortgage loans because of several factors, including dependence on the successful operation of a business or a project for repayment, the collateral securing these loans may not be sold as easily as residential real estate, and loan terms with a balloon payment rather than full amortization over the loan term. In addition, commercial real estate and commercial loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to one- to four-family residential mortgage loans. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan. Underwriting and portfolio management activities cannot completely eliminate all risks related to these loans. Any significant failure to pay on time by our customers or a significant default by our customers would materially and adversely affect us.

We make both secured and some unsecured commercial and industrial loans. Unsecured loans generally involve a higher degree of risk of loss than do secured loans because, without collateral, repayment is wholly dependent upon the success of the borrowers' businesses. Secured commercial and industrial loans are generally collateralized by accounts receivable, inventory, equipment or other assets owned by the borrower and include a personal guaranty of the business owner. Compared to real estate, that type of collateral is more difficult to monitor, its value is harder to ascertain, it may depreciate more rapidly and it may not be as readily saleable if repossessed. Further, commercial and industrial loans generally will be serviced primarily from the operation of the business, which may not be successful, and commercial real estate loans generally will be serviced from income on the properties securing the loans.

While the declines in the value of our real estate collateral securing loans following the recession that began in 2007 have been reflected in existing reserves, the discounts and reserves we have taken against our loan portfolio based on our review of the recent recession's impact on real estate values in our market areas may be insufficient. Further deterioration in the real estate market or a prolonged economic recovery could adversely affect the value of the properties securing the loans or revenues from borrowers' businesses, thereby increasing the risk of non-performing loans and increased portfolio losses that could materially and adversely affect us.

In addition, our commercial borrowers have been impacted by the current economic slowdown as consumers and other businesses have pulled back on spending. Small businesses that make up the majority of our commercial borrowers generally do not have the cash reserves to help cushion them from an economic slowdown to the same extent that large borrowers do and thus may be more heavily impacted by an economic downturn. A continued slow economic recovery may also have a negative effect on the ability of our commercial borrowers to make timely repayments of their loans, which could have an adverse impact on our earnings.

Current market conditions include an over-supply of land, lots and finished homes in many markets, including those where we do business. Construction loans are subject to risks during the construction phase that are not present in standard residential real estate and commercial real estate loans. These risks include:

- the viability of the contractor;
- the value of the project being subject to successful completion;
- the contractor's ability to complete the project, to meet deadlines and time schedules and to stay within cost estimates; and
- concentrations of such loans with a single contractor and its affiliates.

Real estate construction and land loans also present risks of default in the event of declines in property values or volatility in the real estate market during the construction phase. If we are forced to foreclose on a project prior to completion, we may not be able to recover the entire unpaid portion of the loan, may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate amount of time. If any of these risks were to occur, it could adversely affect our financial condition, results of operations and cash flows.

The federal banking agencies have issued guidance regarding high concentrations of commercial real estate loans within bank loan portfolios. The guidance requires financial institutions that exceed certain levels of commercial real estate lending compared with their total capital to maintain heightened risk management practices that address the following key elements: including board and management oversight and strategic planning, portfolio management, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and maintenance of increased capital levels as needed to support the level of commercial real estate lending. If there is any deterioration in our commercial real estate or real estate construction and land portfolios or if our regulators conclude that we have not implemented appropriate risk management practices, it could adversely affect our business and result in a requirement of increased capital levels, and such capital may not be available at that time.

If our allowance for credit losses is not sufficient to cover actual loan losses, our earnings would decrease.

We maintain an allowance for credit losses that we believe is adequate for absorbing any potential losses in our loan portfolio. Management, through a periodic review and consideration of our loan portfolio, determines the amount of the allowance for credit losses. We cannot, however, predict with certainty the amount of probable losses in our portfolio or be sure that our allowance will be adequate in the future. If management's assumptions and judgments prove to be incorrect and the allowance for credit losses is inadequate to absorb future losses, our losses will increase and our earnings will suffer.

In particular, it is more difficult to estimate loan losses for those types of loans - commercial and commercial real estate - that constitute the majority of our portfolio as compared to, for example, residential mortgage loans. Also, because these types of loans tend to have large loan balances, a loss on a single loan could have a significant adverse effect on our operations.

In determining the amount of the allowance for credit losses, we review our loans and our loss and delinquency experience, and evaluate economic conditions. If our assumptions are incorrect, our allowance for credit losses may not be sufficient to cover future incurred losses in our loan portfolio, resulting in additions to the allowance and a corresponding decrease to earnings. Material additions to the allowance could materially decrease our net income. If delinquencies and defaults continue to increase, we may be required to further increase our provision for loan losses.

In addition, bank regulators periodically review our allowance for credit losses and may require an increase in the provision for loan losses or further loan charge-offs to the allowance for credit losses. Any increase in the allowance for credit losses or loan charge-offs might have a material adverse effect on our financial condition and results of operations.

Because our loan portfolio includes residential real estate loans, our earnings are sensitive to the credit risks associated with these types of loans.

We originate and retain in our portfolio residential mortgage loans and intend to increase our origination of these types of loans. While residential real estate loans are more diversified than loans to commercial borrowers, and our local real estate market and economy have performed better than many other markets, a downturn could cause higher unemployment, more delinquencies, and could adversely affect the value of properties securing loans in our portfolio. In addition, should values begin to decline again, the real estate market may take longer to recover or not recover to previous levels. These risks increase the probability of an adverse impact on our financial results as fewer borrowers would be eligible to borrow and property values could be below necessary levels required for adequate coverage on the requested loan.

Proposed and final regulations could restrict our ability to originate residential real estate loans.

The CFPB has issued a rule, effective January 10, 2014, designed to clarify for lenders how they can avoid legal liability under the Dodd-Frank Act, which would otherwise hold lenders accountable for ensuring a borrower’s ability to repay a mortgage. Loans that meet this “qualified mortgage” definition will be presumed to have complied with the new ability-to-repay standard. Under the CFPB’s rule, a “qualified mortgage” loan must not contain certain specified features.

The rule also establishes general underwriting criteria for qualified mortgages, including that the consumer must have a total (or “back end”) debt-to-income ratio that is less than or equal to 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower on the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The CFPB’s rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more costly/and or time consuming to make these loans, which could limit our growth or profitability.

In addition, the Dodd-Frank Act requires the regulatory agencies to issue regulations that require securitizers of loans to retain “not less than 5% of the credit risk for any asset that is not a qualified residential mortgage.” The regulatory agencies initially issued a proposed rule to implement this requirement in April 2011. A revised proposed rule was issued in August 2013. The Dodd-Frank Act provides that the definition of “qualified residential mortgage” can be no broader than the definition of “qualified mortgage” issued by the CFPB for purposes of its regulations. Although the final rule with respect to the retention of credit risk has not yet been issued, the final rule could have a significant effect on the secondary market for loans and the types of loans we originate and intend to originate, and restrict our ability to make residential mortgage loans.

Our profitability depends on interest rates, and changes in interest rates could have an adverse impact on our results of operations and financial condition.

Our results of operations will depend to a large extent on our “net interest income,” which is the difference between the interest expense incurred in connection with our interest-bearing liabilities, such as interest on deposit accounts, and the interest income received from our interest-earning assets, such as loans and investment securities. Changes in interest rates can increase or decrease our net interest income, because different types of assets and liabilities may react differently, and at different times, to market interest rate changes. When interest bearing liabilities mature or reprice more quickly than interest earning assets in a period, an increase in interest rates could reduce net interest income. Similarly, when interest earning assets mature or reprice more quickly than interest bearing liabilities, falling interest rates could reduce net interest income. Additionally, an increase in interest rates may, among other things, reduce the demand for loans and our ability to originate loans and decrease loan repayment rates. A decrease in the general level of interest rates may affect us through, among other things, increased prepayments on our loan and mortgage-backed securities portfolios and increased competition for deposits. Accordingly, changes in the level of market interest rates affect our net yield on interest earning assets, loan origination volume, loan and mortgage-backed securities portfolios, and our overall results. Fluctuations in interest rates are highly sensitive to many factors that are not predictable or controllable. Therefore, while we attempt to manage our risk from changes in market interest rates by adjusting the rates, maturity, repricing, and balances of the different types of interest-earning assets and interest bearing liabilities, we might not be able to maintain a consistent positive spread between the interest that we receive and the interest that we pay. As a result, a rapid increase or decrease in interest rates could have an adverse effect on our net interest margin and results of operations.

Monetary policy and general economic conditions will influence our results of operations.

Governmental economic and monetary policy will influence our results of operations. The rates of interest payable on deposits and chargeable on loans are affected by fiscal policy as determined by various governmental and regulatory authorities, in particular the Federal Reserve, as well as by national, state and local economic conditions. In addition, adverse general economic conditions may impair the ability of our borrowers to repay loans.

Because the Bank serves a limited market area, we could be more adversely affected by an economic downturn in our market area than our larger competitors that are more geographically diverse.

Our current primary market area consists of the Greater Baltimore Metropolitan Area. Broad geographic diversification is not currently part of our community bank focus. As a result, if our market areas suffer an economic downturn, our business and financial condition may be more severely affected by such circumstances. Factors that adversely affect the economy in our target markets could reduce our deposit base and demand for our services and products and increase our credit losses. Consequently, we may be adversely affected, potentially materially, by adverse changes in economic conditions in and around our market areas. Our larger bank competitors, for example, serve more geographically diverse market areas, parts of which may not be affected by the same economic conditions that may exist in our market areas.

Further, unexpected changes in the national and local economy may adversely affect our ability to attract deposits and to make loans. In particular, due to the proximity of our primary and secondary market areas to Washington, D.C., decreases in spending by the Federal government, could impact us more than banks that serve a larger or a different geographical area. Such risks are beyond our control and may have a material adverse effect on our financial condition and results of operations and, in turn, the value of our common stock.

The small to medium-sized businesses that the Bank lends to may have fewer resources to weather a downturn in the economy, which may impair a borrower's ability to repay a loan to the Bank that could materially harm our operating results.

The Bank targets its business development and marketing strategy primarily to serve the banking and financial services needs of small to medium-sized businesses. These small to medium-sized businesses frequently have smaller market share than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience significant volatility in operating results. Any one or more of these factors may impair the borrower's ability to repay a loan. In addition, the success of a small to medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay a loan. Economic downturns and other events that negatively impact our market areas could cause the Bank to incur substantial credit losses that could negatively affect our results of operations and financial condition.

We depend heavily on five key employees, Mary Ann Scully, Robert A. Altieri, Paul G. Brown, Charles E. Schwabe and George C. Coffman, to continue the implementation of our long-term business strategy and the loss of their services could disrupt our operations and result in reduced earnings.

Ms. Scully is our President and Chief Executive Officer, Mr. Altieri is an Executive Vice President, President of our Mortgage Banking Division and our Chief Specialty Lending Officer, Mr. Brown is an Executive Vice President and our Chief Lending Officer, Chief Client Services Officer and Chief Credit Risk Officer, Mr. Schwabe is an Executive Vice President and our Secretary, Chief Administrative Officer, Chief Information Officer and Chief Operational Risk Officer, and Mr. Coffman is an Executive Vice President and our Chief Financial Officer. We believe that our continued growth and future success will depend in large part on the skills of our senior management team. We believe our senior management team possesses valuable knowledge about and experience in the banking industry and that their knowledge and relationships would be difficult to replicate. We have entered into an employment agreement with each of Ms. Scully, Mr. Altieri, Mr. Brown, Mr. Schwabe and Mr. Coffman and acquired key-person life insurance on each such executive officer, but the existence of such agreements and insurance does not assure that we will be able to retain their services or recover losses associated with the loss of their services. The unexpected loss of the services of Ms. Scully, Mr. Altieri, Mr. Brown, Mr. Schwabe or Mr. Coffman could have a material adverse effect on our business, operations, financial condition and operating results, as well as the value of our common stock.

Our growth strategy may not be successful, may be dilutive and may have other adverse consequences.

As previously mentioned, a key component of our growth strategy is to pursue acquisitions of other financial institutions or branches of other financial institutions. As consolidation of the banking industry continues, the competition for suitable acquisition candidates may increase. We compete with other banking companies for acquisition opportunities, and there are a limited number of candidates that meet our acquisition criteria. Consequently, we may not be able to identify suitable candidates for acquisitions. If we are unable to locate suitable acquisition candidates willing to sell on terms acceptable to us, our net income could decline and we would be required to find other methods to grow our business. We may also open additional branches organically and expand into new markets or offer new products and services. These activities would involve a number of risks, including:

- the time and expense associated with identifying and evaluating potential acquisitions and merger partners;
- using inaccurate estimates and judgments to evaluate credit, operations, management and market risks with respect to the target institution or its branches or assets;
- diluting our existing stockholders in an acquisition;
- the time and expense associated with evaluating new markets for expansion, hiring experienced local management and opening new offices or branches as there may be a substantial time lag between these activities before we generate sufficient assets and deposits to support the costs of the expansion;
- operating in markets in which we have had no or only limited experience;
- taking a significant amount of time negotiating a transaction or working on expansion plans, resulting in management’s time and attention being diverted from the operation of our existing business;
- we may not be able to correctly identify profitable or growing markets for new branches;

- the time and expense associated with integrating the operations and personnel of the combined businesses;
- the ability to realize the anticipated benefits of the acquisition;
- creating an adverse short-term effect on our results of operations;
- losing key employees and customers as a result of an acquisition that is poorly received;
- time and costs associated with regulatory approvals;
- lack of information on a target institution or its branches or assets;
- inability to obtain additional financing (including by issuing additional common equity), if necessary, on favorable terms or at all; and
- unforeseen adjustments, write-downs, write-offs or restructuring or other impairment charges.

In addition, we may not be able to integrate successfully or operate profitably any financial institutions we may acquire. We may experience disruption and incur unexpected expenses in integrating acquisitions. Any acquisitions we do make may not enhance our cash flows, business, financial condition, results of operations or prospects and may have an adverse effect on our results of operations, particularly during periods in which the acquisitions are being integrated into our operations.

Also, the costs to lease and start up new branch facilities or to acquire existing financial institutions or branches, and the additional costs to operate these facilities, may increase our noninterest expense. It also may be difficult to adequately and profitably manage the anticipated growth from the new branches. We can provide no assurance that any new branch sites will successfully attract a sufficient level of deposits and other banking business to offset their operating expenses.

Further, we plan to make significant investment in our infrastructure in the immediate future. We also currently plan to open additional branches in the areas where we now operate and in other markets over the next few years. We anticipate that this will have the short-term effect of, at least temporarily, increasing our expenses at a faster rate than revenue growth, which will have an adverse effect on net income.

If we grow too quickly and are not able to control costs and maintain asset quality, growth could materially and adversely affect our financial condition and results of operations. Further, we may not be successful in our growth strategy, which would negatively impact our financial condition and results of operations.

Our need to comply with extensive and complex governmental regulation could have an adverse effect on our business and our growth strategy, and we may be adversely affected by changes in laws and regulations.

The banking industry is subject to extensive regulation by state and federal banking authorities. Many of these regulations are intended to protect depositors, the public or the FDIC insurance funds, not stockholders. Regulatory requirements affect our lending practices, capital structure, investment practices, dividend policy and many other aspects of our business. These requirements may constrain our operations, and changes in regulations could adversely affect us. The burden imposed by these federal and state regulations may place banks in general, and Howard Bank specifically, at a competitive disadvantage compared to less regulated competitors. In addition, the cost of compliance with regulatory requirements could adversely affect our ability to operate profitably or increase profitability. See “Supervision and Regulation” for more information about applicable banking laws and regulations.

Further, regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, classification of our assets and determination of the level of our allowance for credit losses. If regulators require Howard Bank to charge-off loans or increase its allowance for credit losses, our earnings would suffer. Any change in such regulation and oversight, whether in the form of regulatory policy, regulation, legislation or supervisory action, may have a material impact on our operations. For a further discussion, see “Supervision and Regulation.”

In addition, because federal regulation of financial institutions changes regularly and is the subject of constant legislative debate, we cannot forecast how federal regulation of financial institutions may change in the future and impact our operations. Changes in regulation and oversight, including in the form of changes to statutes, regulations or regulatory policies or changes in interpretation or implementation of statutes, regulations or policies, could affect the service and products we offer, increase our operating expenses, increase compliance challenges and otherwise adversely impact our financial performance and condition. In addition, the burden imposed by these federal and state regulations may place banks in general, and Howard Bank specifically, at a competitive disadvantage compared to less regulated competitors.

Further, as a public company, we incur significant legal, accounting, insurance and other expenses in connection with compliance with rules of the SEC and the rules of The NASDAQ Stock Market LLC.

Failure to pay dividends on our Series AA Preferred Stock may have negative consequences, including external involvement in our board of directors.

If dividends on the Series AA Preferred Stock are not paid in full for six quarterly dividend periods, whether or not consecutive, and if the aggregate liquidation preference amount of the then-outstanding shares of Series AA Preferred Stock is at least $25.0 million, the total number of positions on our board of directors will automatically increase by two and the holders of the Series AA Preferred Stock, acting as a single class, will have the right to elect two individuals to serve in the new director positions. This right and the terms of such directors will end when we have paid full dividends for at least four consecutive quarterly dividend periods. If full dividends have not been paid on the Series AA Preferred Stock for five or more quarterly dividend periods, whether or not consecutive, we must invite a representative selected by the holders of a majority of the outstanding shares of Series AA Preferred Stock, voting as a single class, to attend all meetings of our board of directors in a nonvoting observer capacity. Any such representative would not be obligated to attend any board meeting to which he or she is invited, and this right will end when we have paid full dividends for at least four consecutive dividend periods.

Our preferred shares impact net income available to our common stockholders and our earnings per share.

The dividends declared on the Series AA Preferred Stock reduce net income available to common shareholders and our earnings per common share. The Series AA Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of the Company.

The Dodd-Frank Act may adversely impact our results of operations, liquidity or financial condition.

The Dodd-Frank Act, enacted in July 2010, represents a comprehensive overhaul of the U.S. financial services industry. Among other things, the Dodd-Frank Act established the new CFPB, included provisions that allow financial institutions to pay interest on business checking accounts, broadened the base for FDIC insurance assessments, added restrictions on how mortgage brokers and loan originators may be compensated, included additional mortgage origination provisions including risk retention, and added and modified many other regulations applicable to insured depository institutions. The Dodd-Frank Act requires the CFPB and other federal agencies to implement many new and significant rules and regulations to implement its various provisions. There are a number regulations under the Dodd-Frank Act that have not yet been proposed or adopted. We will not know the full impact of the Dodd-Frank Act on our business for years after regulations implementing the statute are adopted and implemented. As a result, we cannot at this time predict the extent to which the Dodd-Frank Act will impact our business, operations or financial condition. However, as regulations under the Dodd-Frank continue to be implemented, compliance with these new laws and regulations may require us to make changes to our business and operations, impose on us more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. These changes will also likely result in additional costs and a diversion of management's time from other business activities and may decrease revenues by, for example, limiting the fees we can charge, any of which may adversely impact our results of operations, liquidity or financial condition. The new duties to be imposed on mortgage lenders, including a duty to determine the borrower's ability to repay the loan and a requirement on mortgage securitizers to retain a minimum level of economic interest in securitized pools of certain mortgage types, may decrease the demand for mortgage loans. Any of these consequences, as well as the failure to comply with new requirements or any future changes in laws or regulations, may adversely impact our results of operations, liquidity or financial condition. For a more detailed description of the Dodd-Frank Act, see "Supervision and Regulation—The Dodd-Frank Act."

Federal and state banking agencies periodically conduct examinations of our business, including compliance with laws and regulations, and our failure to comply with any supervisory actions to which we are or become subject as a result of such examinations may adversely affect us.

State and federal banking agencies, including the FDIC and the Maryland Office of the Commissioner of Financial Regulation, periodically conduct examinations of our business, including compliance with laws and regulations. If, as a result of an examination, a state or federal banking agency were to determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we or our management was in violation of any law or regulation, it may take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin "unsafe or unsound" practices, to require affirmative actions to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate the Bank's deposit insurance. If we become subject to such regulatory actions, our business, results of operations and reputation may be negatively impacted.

Many of our new activities and expansion plans require regulatory approvals, and failure to obtain them may restrict our growth.

We intend to complement and expand our business by pursuing strategic acquisitions of banks and other financial institutions. We must generally receive regulatory approval before we can acquire an institution or business. Such regulatory approvals may not be granted on terms that are acceptable to us, or at all. We may also be required to sell branches as a condition to receiving regulatory approval, which condition may not be acceptable to us or, if acceptable to us, may reduce the benefit of any acquisition.

In addition to the acquisition of existing financial institutions, as opportunities arise, we plan to continue de novo branching as a part of our internal growth strategy and possibly enter into new markets through de novo branching. De novo branching and any acquisition carries with it numerous risks, including the inability to obtain all required regulatory approvals. The failure to obtain these regulatory approvals for potential future strategic acquisitions and de novo branches may impact our business plans and restrict our growth.

We may be required to raise additional capital in the future, but that capital may not be available when it is needed on attractive terms, or at all.

We are required by regulatory authorities to maintain adequate levels of capital to support our operations. Our capital requirements for the foreseeable future are currently satisfied. We may at some point, however, need to raise additional capital to support our continued growth, or if our liquidity is adversely affected by external factors such as worsening economic conditions or continued economic uncertainty. Our ability to raise additional capital, if needed, will depend in part on conditions in the capital markets at that time, which are outside our control. Accordingly, we cannot assure you of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations could be materially impaired, or the failure to raise additional capital could have a material adverse effect on our liquidity, financial condition or results of operations. In addition, if we decide to raise additional equity capital, your interest in Howard Bancorp could be diluted. Furthermore, if we raise additional capital through the issuance of debt securities, there can be no assurance that sufficient revenues or cash flow will exist to service such debt.

The market value of our investments could negatively impact stockholders' equity.

All of our securities investment portfolio as of December 31, 2013 has been designated as available for sale pursuant to Statement of Financial Accounting Standards, Accounting Standards Codification ("ASC") Topic 320 – "Investments. ASC Topic 320 requires that unrealized gains and losses in the estimated value of the available for sale portfolio be "marked to market" and reflected as a separate item in stockholders' equity, net of tax. If the market value of the investment portfolio declines, this could cause a corresponding decline in stockholders' equity.

Our lending limit may limit our growth.

We are limited in the amount we can loan to a single borrower by the amount of our capital. Generally, under current law, we may lend up to 15% of our unimpaired capital and surplus to any one borrower. Based upon our current capital levels, the amount we may lend is significantly less than that of many of our competitors and may discourage potential borrowers who have credit needs in excess of our lending limit from doing business with us. We accommodate larger loans by selling participations in those loans to other financial institutions, but this strategy may not always be available.

We are a community bank and our ability to maintain our reputation is critical to the success of our business and the failure to do so may materially adversely affect our performance.

We are a community bank, and our reputation is one of the most valuable components of our business. As such, we strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. If our reputation is negatively affected, by the actions of our employees or otherwise, our business and, therefore, our operating results may be materially adversely affected.

We are subject to security and operational risks relating to our use of technology that could damage our reputation and our business.

Security breaches in our Internet banking activities or other communication and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations. We rely on standard Internet and other security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures.

Consumers may decide not to use banks to complete their financial transactions.

Technology and other changes are allowing consumers to complete financial transactions through alternative methods that historically have involved banks. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts, mutual funds or general-purpose reloadable prepaid cards. Consumers can also complete transactions such as paying bills and transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost of deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Strong competition within our market area may limit our growth and profitability.

Competition in the banking and financial services industry is intense. In our market area, we compete with, among others, commercial banks, savings institutions, mortgage brokerage firms, credit unions, mutual funds, and insurance companies operating locally and elsewhere. There are also a number of smaller community-based banks that pursue similar operating strategies as Howard Bank. In addition, some of our competitors have recently offered loans with lower fixed rates and loans on more attractive terms than we have been willing to offer. Our continued profitability depends upon our continued ability to successfully compete in our market area. The greater resources and deposit and loan products offered by our competition may limit our ability to increase our interest earning assets. See “Item 1. Business—Competition” for more information about competition in our market area.

The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Increased competition among financial services companies due to the recent consolidation of certain competing financial institutions may adversely affect our ability to market our products and services. Also, technology has lowered barriers to entry and made it possible for banks to compete in our market without a retail footprint by offering competitive rates, as well as non-banks to offer products and services traditionally provided by banks. Additionally, due to their size, many competitors may offer a broader range of products and services as well as better pricing for certain products and services than we can, which could affect our ability to grow and remain profitable on a long-term basis. Our profitability depends upon our ability to successfully compete in our market area. If we must raise interest rates paid on deposits or lower interest rates charged on our loans, our net interest margin and profitability could be adversely affected.

Anti-takeover provisions in our corporate documents and in Maryland corporate law may make it difficult and expensive to remove current management.

Anti-takeover provisions in our corporate documents and in Maryland law may render the removal of our existing board of directors and management more difficult. Consequently, it may be difficult and expensive for our stockholders to remove current management, even if current management is not performing adequately.

Our articles of incorporation limit the liability of our directors and officers.

Our articles of incorporation provide that, to the full extent permitted by Maryland law, no director or officer of Howard Bancorp will be liable to us or our stockholders for money damages. This limitation could impair the ability of us and our stockholders to recover for damages resulting from acts or omissions of our directors and officers.

The market price for our common stock may be volatile.

The market price of our common stock could be subject to significant fluctuations due to changes in sentiment in the market regarding our operations or business prospects. Factors that may affect market sentiment include:

- operating results that vary from the expectations of our management or of securities analysts and investors;
- developments in our business or in the financial service sector generally;

- regulatory or legislative changes affecting our industry generally or our business and operations in particular;
- operating and securities price performance of companies that investors consider to be comparable to us;
- changes in estimates or recommendations by securities analysts;
- announcements of strategic developments, acquisitions, dispositions, financings and other material events by us or our competitors; and
- changes in financial markets and national and local economies and general market conditions, such as interest rates and stock, commodity, credit or asset valuations or volatility.

While the U.S. and other governments continue efforts to restore confidence in financial markets and promote economic growth, market and economic turmoil could still occur in the near- or long-term, negatively affecting our business, financial condition and results of operations, as well as the price, trading volume and volatility of our common stock.

We can sell additional shares of common stock without consulting stockholders and without offering shares to existing stockholders, which would result in dilution of stockholders' interests in Howard Bancorp and could depress our stock price.

Our articles of incorporation currently authorize an aggregate of 10 million shares of common stock, 4,095,650 of which are outstanding as of the date of this report, 119,376 of which are reserved for issuance pursuant to outstanding warrants, 387,101 of which are reserved for issuance pursuant to outstanding options granted under our stock incentive plans and employment agreements and 684,897 of which are reserved for issuance pursuant to future grants under our stock incentive plans. Our board of directors has the authority to amend our articles of incorporation, without stockholder approval, to increase or decrease the aggregate number of shares of stock or the number of shares of any class of stock that we have the authority to issue. The board of directors is further authorized to issue additional shares of common stock and preferred stock, at such times and for such consideration as it may determine, without stockholder action. The ability of the board of directors to increase our authorized shares of capital stock, and the existence of authorized but unissued shares of common stock and preferred stock, could have the effect of rendering more difficult or discouraging hostile takeover attempts, or of facilitating a negotiated acquisition and could affect the market for and price of our common stock. Because our common stockholders do not have preemptive rights to purchase shares of our capital stock (that is, the right to purchase a stockholder's pro rata share of any securities issued by Howard Bancorp), any future offering of capital stock could have a dilutive effect on holders of our common stock.

Item 1B. Unresolved Staff Comments

Not applicable

Item 2. Properties

The Company leases its headquarters located at Columbia 100 Corporate Park in Ellicott City, Maryland (6011 University Blvd.). The headquarters' space is approximately 8,700 square feet on the 3rd floor. A full service branch is located on the ground floor of the building and contains approximately 2,850 square feet. A separate drive-thru facility is adjacent to this building. Howard Bank operates six additional full service branches, leasing all of them except for our Ellicott City Branch and our Aberdeen Branch, and also leases regional offices in Annapolis and Towson, as further described below.

Our second branch is located in the Hickory Ridge Village Center in Columbia, Maryland (6430 Freetown Rd.), and consists of an approximate 2,400 square foot full service branch and a three lane drive-thru facility. The lease for this location expires on June 30, 2014, and we plan to close this branch at the lease expiration.

A third branch is located in Maple Lawn near the intersection of Johns Hopkins Road and Old Columbia Road/Route 29 in Laurel, Maryland (10985 John Hopkins Road) and consists of an approximate 3,000 square foot full service branch and a three lane drive-thru facility.

We own the property on U.S. Route 40 at 10163 Baltimore National Pike, Ellicott City, MD 21042 at which we operate an approximate 3,100 square foot full service branch and a three lane drive-thru facility. An additional commercial building on this property includes approximately 9,000 square feet of retail space on the ground floor and an additional approximate 5,900 square feet of office space on the second floor that we use for our operations and support functions.

Our Annapolis branch is located on the first floor of a building at 116 Defense Highway in Annapolis, Maryland. We lease approximately 2,756 square feet of space and in the second quarter of 2012 relocated the limited branch services previously operated out of our Annapolis office to this full service branch.

Our Aberdeen branch, which we purchased from Cecil Bank in August 2013, consists of approximately 1,512 square feet and a two lane drive through facility. Along with both deposit accounts and loans, we acquired the branch real estate from Cecil Bank which is now fully owned by the Bank.

In November 2013, we opened an approximately 2,700 square foot regional office, which is in Towson, Maryland. This office houses lending, business development and relationship management functions. Simultaneously, in the adjacent space to our regional office, we opened our Towson Branch which is approximately 3,000 square feet located on the first floor of a building at 22 West Pennsylvania Avenue in Towson, Maryland.

We also maintain an approximately 2,400 square foot regional office that functions as a regional office, which we opened in 2010, in the Annapolis Exchange Building in Annapolis, Maryland (197 Annapolis Exchange Parkway, Suite 140). This office houses lending, business development and relationship management functions.

Item 3. Legal Proceedings

From time to time, we may be involved in litigation relating to claims arising out of our normal course of business. As of the date of this report, we are not aware of any material pending litigation matters.

Item 4. Mine Safety Disclosures

Not applicable

Part II

Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities

Our common stock is listed on The NASDAQ Stock Market under the symbol “HBMD.” Prior to July 23, 2012, our stock was quoted on the Over-The-Counter Bulletin Board (the “OTCBB”).

The following table reflects the high and low sale prices for the periods presented. Quotations for 2013 and the third and fourth quarters of 2012 are based on NASDAQ listings and reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions; quotations for the first two quarters of 2012 is based on information posted on the OTCBB by broker dealers and these prices may include dealer mark-up, mark-down and/or commission and may not necessarily represent actual transactions.

	2013		2012	
	Stock price range		Stock price range	
Quarter	High	Low	High	Low
First	$ 7.09	$ 6.10	$ 5.40	$ 4.51
Second	8.02	6.85	7.35	5.40
Third	9.10	7.26	9.55	6.55
Fourth	10.10	8.24	7.56	6.01

At February 28, 2014, we had 320 stockholders of record.

Dividends

We have not paid any dividends on our common stock since our inception and we presently do not intend to pay any dividends in the foreseeable future. We expect that we will retain all earnings, if any, for operating capital. Our ability to pay dividends is dependent upon, among other things, restrictions imposed by the reserve and capital requirements of Maryland and federal law and regulations, our income and financial condition, tax considerations, and general business conditions. In addition, there are restrictions on our ability to pay dividends on our common stock if we are in arrears in the required dividend payment on our Series AA Preferred Stock.

Use of Proceeds from Initial Public Offering

Our registration statement on Form S-1, File Number 333-178204, with respect to our initial public offering of our common stock, was declared effective by the Securities and Exchange Commission on May 14, 2012. We sold a total of 1,396,364 shares of common stock in our initial public offering for aggregate gross proceeds of $10.2 million.

After expenses, we raised net proceeds of approximately $9.0 million in the public offering. The proceeds have been utilized to increase the capital levels of the Bank and deployed into additional loans and other assets.

Item 6. Selected Financial Data

	Year ended December 31,				
(in thousands, except per share data.)	2013	2012	2011	2010	2009
Operation Statement Data:					
Interest income	$17,711	$15,537	$14,640	$14,255	$12,426
Interest expense	1,901	2,005	2,017	2,907	3,744
Provision for credit losses	950	718	1,164	1,633	3,670
Noninterest income	1,324	768	1,137	741	756
Noninterest expense	13,239	10,823	10,148	8,707	9,260
Federal and state income tax expense (benefit)	984	1,138	1,063	816	(1,304)
Net income (loss)	1,961	1,621	1,385	933	(2,188)
Dividends	165	616	451	326	274
Net income (loss) available to common shareholder	1,796	1,005	934	607	(2,462)
Per share data and shares outstanding:					
Net income per common share, basic	$0.44	$0.31	$0.35	$0.23	$(0.94)
Net income per common share, diluted	$0.44	$0.31	$0.35	$0.23	$(0.94)
Book value per common share at period end	$8.80	$8.45	$9.12	$8.73	$8.44
Average common shares outstanding	4,077,613	3,269,835	2,638,443	2,634,822	2,633,066
Diluted average common shares outstanding	4,081,011	3,269,835	2,638,443	2,634,822	2,633,066
Shares outstanding at period end	4,095,650	4,040,471	2,640,264	2,636,837	2,633,836
Financial Condition data:					
Total assets	$499,918	$401,675	$323,082	$300,219	$286,296
Loans receivable (gross)	403,875	322,218	276,531	256,307	252,745
Allowance for credit losses	2,506	2,764	3,433	3,523	3,508
Other interest-earning assets	60,481	38,972	15,614	15,338	20,277
Total deposits	388,949	314,858	262,642	239,314	228,743
Borrowings	61,658	38,987	22,984	31,024	28,458
Total stockholders’ equity	48,624	46,721	36,630	29,288	28,514
Common equity	36,062	34,159	24,068	23,016	22,242
Average asset	428,961	356,355	306,567	302,095	257,249
Average stockholders' equity	47,717	41,338	31,749	29,004	30,069
Average common stockholders' equity	35,155	28,776	23,737	22,732	24,775
Selected performance ratios:					
Return on average assets	0.46%	0.45%	0.45%	0.31%	(0.85)%
Return on average common equity	5.58%	5.63%	5.83%	4.10%	(8.83)%
Net interest margin[1]	3.93%	3.98%	4.37%	4.01%	3.54%

Efficiency ratio(2)	77.27	%	75.69	%	73.75	%	72.02	%	98.11	%
Asset quality ratios:										
Nonperforming loans to gross loans	0.79	%	0.75	%	2.13	%	2.20	%	3.03	%
Allowance for credit losses to loans	0.62	%	0.86	%	1.24	%	1.37	%	1.39	%
Allowance for credit losses to nonperforming loans	78.76	%	115.12	%	58.40	%	62.36	%	45.86	%
Nonperforming assets to loans and other real estate	1.37	%	1.63	%	2.79	%	3.34	%	3.35	%
Nonperforming assets to total assets	1.11	%	1.32	%	2.40	%	2.89	%	2.97	%
Capital ratios:										
Leverage ratio	9.93	%	12.34	%	11.52	%	9.52	%	10.08	%
Tier I risk-based capital ratio	11.45	%	14.18	%	13.14	%	11.14	%	11.30	%
Total risk-based capital ratio	12.05	%	15.02	%	14.36	%	12.39	%	12.55	%
Average equity to average assets	11.12	%	11.60	%	10.36	%	9.60	%	11.69	%

(1) Net interest margin is net interest income divided by average earning assets.

(2) Efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

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Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

This section is intended to help potential investors understand our financial performance through a discussion of the factors affecting our consolidated financial condition at December 31, 2013, 2012 and 2011. This section should be read in conjunction with the Consolidated Financial Statements and notes to the consolidated financial statements that appear elsewhere in this report.

Overview

Howard Bancorp, Inc. is the holding company for Howard Bank. Howard Bank is a trust company chartered under Subtitle 2 of Title 3 of the Financial Institutions Article of the Annotated Code of Maryland. The Bank was formed in March 2004 and commenced banking operations on August 9, 2004. Howard Bank does not exercise trust powers, and our regulatory structure is the same as a Maryland-chartered commercial bank. As such, our business has consisted primarily of originating both commercial and real estate loans secured by property in our market area. Typically, commercial real estate and business loans involve a higher degree of risk and carry a higher yield than one-to four-family residential loans. Although we plan to continue to focus on commercial customers, we intend to increase our originations of one- to four-family residential mortgage loans going forward, increasing our portfolio of mortgage lending and also selling select loans into the secondary markets.

We are headquartered in Ellicott City, Maryland and we consider our primary market area to be The Greater Baltimore Metropolitan Area. We engage in a general commercial banking business, making various types of loans and accepting deposits. We market our financial services to small to medium sized businesses and their owners, professionals and executives, and high-net-worth individuals. Our loans are primarily funded by core deposits of customers in our market.

Our core business strategy is to deliver superior customer service that is supported by an extremely high level of banking sophistication. Our specialized community banking focus on both local markets and small business related market segments is combined with a broad array of products, new technology and seasoned banking professionals which positions the Bank differently than most competitors. Our experienced executives establish a relationship with each client and bring value to all phases of a client’s business and personal banking needs. We call it Hands-On Service.

Our results of operations depend mainly on our net interest income, which is the difference between the interest income we earn on our loan and investment portfolios and the interest expense we pay on deposits and borrowings. Results of operations are also affected by provisions for credit losses, noninterest income and noninterest expense. Our noninterest expense consists primarily of compensation and employee benefits, as well as office occupancy, deposit insurance and general administrative and data processing expenses. Our operations are significantly affected by general economic and competitive conditions, particularly with respect to changes in interest rates, government policies and actions of regulatory authorities. Future changes in applicable law, regulations or government policies may materially affect our financial condition and results of operations.

As noted above, in August 2013, Howard Bank purchased from Cecil Bank its branch located at 3 West Bel Air Avenue, Aberdeen, Maryland. Pursuant to the transaction, Howard Bank acquired $37.1 million in loans and $35.2 million in deposits from Cecil Bank, as well as the branch premises and equipment at their book value. In connection with its purchase of the branch from Cecil Bank, Howard Bank made a net cash payment to Cecil Bank of $3.2 million, including a premium of approximately $240,000. This transaction was recorded as an asset acquisition.

For the year ended December 31, 2013, we reported net income of $1.96 million compared to net income of $1.62 million in 2012, an increase of $341 thousand or 21%. Driven by continued balance sheet growth, net interest income increased to $15.8 million in 2013, which represented an increase of $2.3 million or 17% compared to 2012. Partially offsetting the increase in net interest income, the provision for loan losses in 2013 of $950 thousand was $232 thousand or 32% higher than the 2012 provision of $718 thousand. Noninterest income also increased, to $1.3 million during 2013 compared to $768 thousand for 2012, representing an increase of $556 thousand or 73%. The largest contributor to the increased noninterest revenues was the initiation of a Bank Owned Life Insurance (BOLI) program in January 2013, which generated $282 thousand of income during 2013. In addition to the BOLI income, year over year service charges on deposits and mortgage banking gains increased by 20% and 76%, respectively, during 2013. Total noninterest expenses for 2013 of $13.2 million increased by $2.4 million or 22% over total noninterest expenses of $10.8 million in 2012. Compensation expenses, which accounted for more than half of the total increase in expenses, grew by $1.3 million or 22% during 2013 compared to 2012 due to increases in staffing as we continue to open new branch and regional office locations, and also commenced the building and staffing of our new mortgage division. With our geographic expansion, we also increased our advertising and business development expenditures to support our entrée into the new markets and saw increased professional fees associated with the successful initiative to supplement organic growth with acquired growth. Also in 2013, we recorded $347 thousand in expense due to a decreased valuation on one of our foreclosed properties, while this same expense for 2012 was only $48 thousand, representing a year over year increase of $299 thousand, as work towards disposal of the residual nonperforming assets on the balance sheet continues.

During the year ended December 31, 2012, our net interest income increased $0.9 million, or 7.0%, compared to the year ended December 31, 2011, primarily as a result of an increase in interest income on loans during the 2012 period. We had net income available to common shareholders of $1.0 million for the year ended December 31, 2012 compared to $934 thousand for the year ended December 31, 2011, a $71 thousand or 7.6% increase. This increase was a result of the increased net interest income and a decrease in the provision for credit losses, partially offset by an increase in noninterest expenses due to increased compensation costs of a growing company, and also a reduction in the level of noninterest income as 2011 included a gain on the sale of real estate, while 2012 reflected a loss on a sale. In addition, there was also a 36.6% increase in dividends paid on preferred stock based upon the higher 2012 average balance. Comparing December 31, 2012 to the same period in 2011, total assets, total loans, and total deposits grew by 24.3%, 16.5%, and 19.9% respectively. Included in this overall deposit growth were our noninterest-bearing deposits which increased $33.8 million or 54.5%. These highly coveted deposits are the most indicative of our growth in overall core relationships.

Our nonperforming assets totaled $5.6 million, or 1.11% of total assets, at December 31, 2013, compared to $5.3 million, or 1.32% of total assets, at December 31, 2012 and $7.8 million, or 2.4% of total assets, at December 31, 2011. We had two loans totaling $455 thousand delinquent more than 90 days and still accruing at December 31, 2013 compared to $249 thousand (two loans) and $90 thousand (one loan) of such delinquencies at December 31, 2012 and December 31, 2011, respectively. In addition, we provided $950 thousand for credit losses for the year ended December 31, 2013 compared to $718 thousand for credit losses during the year ended December 31, 2012 and $1.2 million during the year ended December 31, 2011, due to the increase loan volume.

Critical Accounting Policies

Our accounting and financial reporting policies conform to the accounting principles generally accepted in the United States of America and general practice within the banking industry. Accordingly, the financial statements require management to exercise significant judgment or discretion or make significant assumptions based on the information available that have, or could have, a material impact on the carrying value of certain assets or on income. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the periods presented. In reviewing and understanding financial information for us, you are encouraged to read and understand the significant accounting policies used in preparing our financial statements. We consider the allowance for credit losses to be our most significant accounting policy, which is further described in the notes to our financial statements.

Allowance for credit losses

The allowance for credit losses is established through a provision for credit losses charged against income. Loans are charged against the allowance for credit losses when management believes that the collectability of the principal is unlikely. Subsequent recoveries are added to the allowance. The allowance is an amount that represents the amount of probable and reasonably estimable known and inherent losses in the loan portfolio, based on evaluations of the collectability of loans. The evaluations take into consideration such factors as changes in the types and amount of loans in the loan portfolio, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, estimated losses relating to specifically identified loans, and current economic conditions. This evaluation is inherently subjective as it requires material estimates including, among others, exposure at default, the amount and timing of expected future cash flows on impacted loans, value of collateral, estimated losses on our loan portfolios as well as consideration of general loss experience. Based on our estimate of the level of allowance for credit losses required, we record a provision for credit losses to maintain the allowance for credit losses at an appropriate level.

We cannot predict with certainty the amount of loan charge-offs that we will incur. We do not currently determine a range of loss with respect to the allowance for credit losses. In addition, our regulatory agencies, as an integral part of their examination processes, periodically review our allowance for credit losses. Such agencies may require that we recognize additions to the allowance for credit losses based on their judgments about information available to them at the time of their examination. To the extent that actual outcomes differ from management's estimates, additional provisions to the allowance for credit losses may be required that would adversely impact earnings in future periods.

Income taxes

We account for income taxes under the asset/liability method. We recognize deferred tax assets for the future consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as operating loss and tax credit carry-forwards. We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize the effect on deferred tax assets and liabilities of a change in tax rates in income in the period indicated by the enactment date. We establish a valuation allowance for deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. The judgment about the level of future taxable income is dependent to a great extent on matters that may, at least in part, be beyond our control. It is at least reasonably possible that management's judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

Share based compensation

We follow the provisions of ASC Topic 718 "Compensation – Stock Compensation" which requires the expense recognition over the respective service period for the fair value of share based compensation awards, such as stock options, restricted stock, and performance based shares. This standard allows management to establish modeling assumptions as to expected stock price volatility, option terms, forfeiture rates and dividend rates which directly impact estimated fair value. The accounting standard also allows for the use of alternative option pricing models which may impact fair value as determined. Our practice is to utilize reasonable and supportable assumptions which are reviewed with the appropriate board Committee.

Balance Sheet Analysis and Comparison of Financial Condition

A comparison between December 31, 2013 and December 31, 2012 balance sheets are presented below.

Assets

Total assets increased $98.2 million, or 24.5%, to $499.9 million at December 31, 2013 compared to $401.7 million at December 31, 2012. This increase in assets was primarily due to an $81.7 million, or 25.3%, increase in loans, to $403.9 million at December 31, 2013 from $322.2 million at December 31, 2012. In addition to the $37.1 million in loans purchased in the Aberdeen branch acquisition, the Bank had organic growth of $44.6 million or 13.8% in loans during 2013. In addition, the Company purchased $11.0 million in BOLI during 2013 as it implemented its BOLI program. The growth in assets was funded primarily from increases in customer deposits, which increased from $314.9 million at December 31, 2012 to $388.9 million at December 31, 2013, an increase of $74.1 million or 23.5%. This deposit growth included approximately $35.2 million in additional deposits acquired in the Aberdeen branch acquisition. Supplementing the deposit growth, additional funding was provided by an increase in both short term and long term borrowings during 2013. Total borrowed funds increased by $22.7 million or 58.2% during 2013, primarily due to the lower interest rates on these sources of funds, which made it more efficient to use borrowings to fund asset growth as opposed to deposits. In addition, our total capital levels increased $1.9 million or 24.5% year over year, due primarily to annual earnings.

Securities Available for Sale

We currently hold both U.S. agency securities and mortgage backed securities in our securities portfolio, all of which are considered as available for sale. We use our securities portfolio to provide the required collateral for funding via commercial customer repurchase agreements as well as to provide sufficient liquidity to fund our loans and provide funds for withdrawals of deposited funds. At December 31, 2013 and December 31, 2012 we held an investment in stock of the Federal Home Loan Bank of Atlanta ("FHLB") of $2.3 million and $1.5 million, respectively. This investment, which is required for continued membership, is based partially upon the dollar amount of borrowings outstanding from the FHLB. These investments are carried at cost. We have never held stock in Fannie Mae or Freddie Mac.

The following tables set forth the composition of our investment securities portfolio at the dates indicated.

(in thousands)	December 31, 2013				2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	$28,522	$ 1	$ 2	$ 28,521	$26,526	$ 14	$ -	$ 26,540
Mortgage-backed	157	10	-	167	314	21	-	335
	$28,679	$ 11	$ 2	$ 28,688	$26,840	$ 35	$ -	$ 26,875

We had securities available for sale of $28.7 million and $26.9 million at December 31, 2013 and December 31, 2012, respectively, which were recorded at fair value. This represents a slight increase of $1.8 million, or 6.7%, for the year ended December, 2013 from the prior year end. We did not record any gains or losses on the sales or calls of agency securities or mortgage backed securities in either of the years ended December 31, 2013 or 2012.

With respect to our portfolio of securities available for sale, the portfolio contained eight securities with an unrealized loss of $1,975 dollars and one security with unrealized losses of $52 dollars at December 31, 2013 and 2012, respectively. Changes in the fair value of these securities resulted primarily from interest rate fluctuations. We do not intend to sell these securities nor is it more likely than not that we would be required to sell these securities before their anticipated recovery, and we believe the collection of the investment and related interest is probable. Based on this analysis, we consider all of the unrealized losses to be temporary impairment losses.

Portfolio Maturities and Yields

The composition and maturities of the investment securities portfolio at December 31, 2013 is summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur.

	As of December 31, 2013									
(in thousands)	One year or less		After one through five years		After five through ten years		After ten years		Total	
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
U.S. Government Agencies	$28,522	0.10 %	$ -	- %	$ -	- %	$ -	- %	$28,522	0.10 %
Mortgage-backed	-	-	51	5.04	106	4.86	-	-	157	4.92
	$28,522	0.10 %	$ 51	5.04 %	$ 106	4.84 %	$ -	%	$28,679	0.12 %

Loan and Lease Portfolio

Total loans and leases increased by $81.7 million or 25.3%, to $403.9 million at December 31, 2013 from $322.2 million at December 31, 2012. At December 31, 2013, total loans were 80.8% of total assets compared to 80.2% of total assets at December 31, 2012. Loan growth throughout the banking industry has been hampered by decreased loan demand resulting from uncertain economic conditions. As previously stated, loan growth during 2013 benefited from the purchase of $37.1 million in loans in the Aberdeen branch acquisition.

The following table sets forth the composition of our loan portfolio at the dates indicated. In addition to the loans we hold in our portfolio, we had loans held for sale of $3.3 million at December 31, 2013, and $1.6 million at December 31, 2012.

	December 31,									
(dollars in thousands)	2013		2012		2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percen
Real Estate										
Construction and land	$50,884	12.6 %	$37,963	11.8 %	$39,268	14.2 %	$30,604	11.9 %	$33,437	13.2
Residential - first lien	39,249	9.7	29,826	9.3	22,087	8.0	22,309	8.7	20,202	8.0
Residential - junior lien	8,266	2.0	7,983	2.5	9,242	3.3	9,889	3.9	10,401	4.1
	47,515	11.7	37,809	11.7	31,329	11.3	32,198	12.6	30,603	12.1

Total residential real estate										
Commercial - owner occupied	90,333	22.4	61,119	19.0	46,588	16.8	46,947	18.3	43,397	17.2
Commercial - non-owner occupied	113,559	28.1	96,223	29.9	76,880	27.8	58,438	22.8	51,193	20.3
Total commercial real estate	203,892	50.5	157,342	48.8	123,468	44.6	105,385	41.1	94,590	37.4
Total real estate loans	302,291	74.8	233,114	72.3	194,065	70.2	168,187	65.6	158,630	62.8
Commercial loans and leases	100,410	24.9	87,844	27.3	81,243	29.4	86,851	33.9	92,816	36.7
Consumer loans	1,174	0.3	1,260	0.4	1,223	0.4	1,269	0.5	1,299	0.5
Total loans and leases	$403,875	100.0%	$322,218	100.0%	$276,531	100.0%	$256,307	100.0%	$252,745	100.0

As is evident in the above table, we are primarily focused on lending to businesses for both commercial financing loans, and also commercial real estate lending. Although there is a small amount of residential and consumer loans, our business model has always been to focus on the needs of small to mid-sized businesses and their owners. With the expansion of our mortgage banking activities, we expect our residential real estate lending to increase.

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Loan Portfolio Maturities

The following table summarizes the scheduled repayments of our loan portfolio and sets forth the scheduled repayments of fixed and adjustable rate loans in our portfolio at December 31, 2013.

	As of December 31, 2013			
(dollars in thousands)	One year or less	After one through five years	After five years	Total
Real Estate				
Construction and land	$21,973	$ 23,837	$ 5,074	$50,884
Residential - first lien	-	-	39,249	39,249
Residential - junior lien	-	1,742	6,524	8,266
Total residential real estate	-	1,742	45,773	47,515
Commercial - owner occupied	6,065	35,853	48,415	90,333
Commercial - non-owner occupied	13,980	47,522	52,057	113,559
Total commercial real estate	20,045	83,375	100,472	203,892
Total real estate loans	42,018	108,954	151,319	302,291
Commercial loans and leases	10,943	28,671	60,796	100,410
Consumer loans	586	557	31	1,174
Total	$53,547	$ 138,182	$ 212,146	$403,875
Rate terms:				
Fixed rate	$25,479	$ 91,384	$ 126,362	$243,225
Adjustable rate	28,068	46,798	85,784	160,650
Total	$53,547	$ 138,182	$ 212,146	$403,875

Deposits

We accept deposits primarily from the areas in which our branches and offices are located. We have consistently focused on building broader customer relationships and targeting small business customers to increase our core deposits. We also rely on our customer service to attract and retain deposits. We offer a variety of deposit accounts with a range of interest rates and terms. Customer deposits have historically provided us with a sizeable source of relatively stable and low-cost funds to support asset growth. Our deposit accounts consist of commercial and retail checking accounts, savings accounts, certificates of deposit, money market accounts, and individual retirement accounts. We do not currently accept brokered deposits other than those obtained under Promontory Interfinancial Network’s certificate of deposit account registry service (“CDARS”) program.

We review and update interest rates paid, maturity terms, service fees and withdrawal penalties on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market interest rates, liquidity requirements, anticipated short term loan demand and our deposit growth goals.

Our deposits increased from $314.9 million at December 31, 2012 to $388.9 million at December 31, 2013, an increase of $74.1 million or 23.5%; this growth includes the $35.2 million purchased in the Aberdeen branch acquisition. Our noninterest bearing demand deposit account balances at the end of 2012 included a large deposit by one customer that exceeded $10.2 million. These funds were withdrawn early in 2013, and account for the decline when comparing 2013 to 2012. Excluding this one customer, other noninterest bearing demand deposit account balances increased during 2013. As detailed in the table below, all other categories of deposits reflected growth in 2013. The growth in deposits funded 90.7% of the year over year growth in loans, with borrowings comprising the majority of the additional funding of asset growth.

The following tables set forth the distribution of total deposit accounts, by account type, at the dates indicated

(dollars in thousands)	December 31, 2013			2012			2011		
	Amount	% of Total	Weighted Average Rate	Amount	% of Total	Weighted Average Rate	Amount	% of Total	Weighted Average Rate
Noninterest-bearing demand	$89,759	23 %	- %	$95,875	30 %	- %	$62,044	24 %	- %
Interest-bearing checking	31,443	8	0.27	26,209	8	0.34	17,687	7	0.43
Money market accounts	96,365	25	0.40	70,856	23	0.55	61,267	23	0.70
Savings	12,496	3	0.34	11,107	4	0.51	10,644	4	0.65
Certificates of deposit $100,000 and over	110,516	29	1.20	77,759	25	1.27	79,718	30	1.21
Certificates of deposit under $100,000	48,370	12	0.72	33,052	10	1.01	31,282	12	1.06
Total deposits	$388,949	100 %	0.67 %	$314,858	100 %	0.85 %	$262,642	100 %	0.91 %

As of December 31, 2013 and 2012, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to $100,000 was $110.5 million and $77.8 million, respectively. The following table sets forth the maturity of those certificates at December 31, 2013.

(in thousands)	December 31, 2013
Three months or less	$ 18,844
Over three to six months	18,823
Over six to twelve months	33,496
Over one year	39,353
	$ 110,516

Borrowings

Customer deposits remain the primary source of borrowing we utilize to meet funding needs. Other borrowings used consist of overnight unsecured master notes, overnight securities sold under agreement to repurchase ("repurchase agreements") and FHLB advances. Our borrowings totaled $61.7 million at December 31, 2013 and $39.0 million at December 31, 2012. Short-term borrowings are summarized on the following table:

	December 31,					
	2013		2012		2011	
(dollars in thousands)	Amount	Rate	Amount	Rate	Amount	Rate
Securities Sold Under Agreement to Repurchase & Master Notes						
At period end	$21,658	0.12%	$16,987	0.40%	$6,984	0.62%
Average for the year	$15,697	0.27%	$17,288	0.45%	$12,211	0.39%
Maximum month-end balance	$24,644		$23,726		$17,379	
Federal Funds Purchased and Short-term Borrowed Funds						
At period end	$24,000	0.43%	$10,000	0.79%	$6,000	0.59%
Average for the year	$12,762	0.57%	$6,468	1.33%	$9,629	0.98%
Maximum month-end balance	$24,000		$11,000		$12,500	

Short-term borrowing totaled $45.7 million at December 31, 2013 and $27.0 million at December 31, 2012. Short-term borrowing consist of overnight electronic sweep products that move customer excess funds from non-interest bearing account to interest bearing ones. Master notes sweep funds from the Bank's customer accounts to the Company and do not require collateral. Repurchase agreements sweep funds within the Bank and are secured primarily by pledges of U.S. Government Agency securities, based upon their fair value, as collateral for 100% of the principal and accrued interest of its repurchase agreements. At December 31, 2013 and 2012 there were $21.7 million and $16.6 million, respectively in borrowings under these repurchase agreements. We did not utilize any Federal funds purchased at December 31, 2013 or December 31, 2012. At December 31, 2013 we had 11 advances outstanding totaling $24.0 million and at December 31, 2012 there were five advances outstanding totaling $10.0 million in short-term advances outstanding under borrowings from the FHLB.

Total Shareholders' Equity

Total shareholders' equity increased by $1.9 million or 4.1% from $46.7 million at December 31, 2012 to $48.6 million at December 31, 2013. The increase in shareholder's equity is primarily the result of annual earnings. Total shareholders' equity at December 31, 2013 represents a capital to asset ratio of 9.7%, while the total shareholders' equity at December 31, 2012 represents a capital to asset ratio of 11.6%.

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Average Balance and Yields

The following tables set forth average balance sheets, average yields and costs, and certain other information for the periods indicated. No tax-equivalent yield adjustments were made, as the effect thereof was not material. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances, and have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense.

	For the years ended December 31,								
	2013			2012			2011		
(dollars in thousands)	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate
Earning assets									
Loans and leases: [1]									
Commercial loans and leases	$93,554	$4,565	4.88 %	$81,056	$4,363	5.38 %	$84,384	$4,758	5.64 %
Commercial real estate	179,023	8,834	4.93	135,284	7,364	5.44	108,073	6,318	5.85
Construction and land	44,276	2,284	5.16	37,830	2,017	5.33	34,252	1,732	5.06
Residential real estate	40,664	1,838	4.52	32,292	1,561	4.83	32,880	1,646	5.01
Consumer	1,097	59	5.33	1,587	75	4.73	1,250	62	4.96
Total loans and leases	358,614	17,579	4.90	288,050	15,380	5.34	260,839	14,516	5.57
Federal funds sold	25,338	54	0.21	25,960	55	0.21	11,891	22	0.19
Securities: [2]									
U.S Gov agencies	16,725	26	0.16	23,947	55	0.23	13,845	45	0.33
Mortgage-backed	245	11	4.56	472	22	4.66	816	40	4.90
Other investments	1,825	40	2.20	1,208	25	2.07	1,459	17	1.17
Total securities	18,795	78	0.41	25,627	102	0.40	16,120	102	0.63
Total earning assets	402,747	17,711	4.40	339,637	15,537	4.57	288,850	14,640	5.07
Cash and due from banks	4,861			3,781			3,209		
Bank premises and equipment, net	9,855			9,656			9,264		
Other assets	14,484			6,429			9,136		
Less: allowance for credit losses	(2,986)			(3,147)			(3,890)		
Total assets	$428,961			$356,355			$306,569		
Interest-bearing liabilities									
Deposits:									
Interest-bearing demand accounts	$25,866	$69	0.27 %	$18,997	$64	0.34 %	$15,859	$68	0.43
Money market	81,345	327	0.40	65,603	362	0.55	62,448	438	0.70

Savings	12,270	42	0.34	11,705	60	0.51	11,974	78	0.65
Time deposits $100,000 and over	60,188	722	1.20	60,605	772	1.27	58,845	715	1.21
Other time deposits	68,894	496	0.72	51,803	521	1.01	42,322	449	1.06
Total interest-bearing deposits	248,563	1,656	0.67	208,712	1,779	0.85	191,448	1,748	0.91
Short-term borrowings	28,459	114	0.40	23,749	163	0.69	21,840	168	0.77
Long-term borrowings	16,521	131	0.79	7,262	64	0.88	7,666	101	1.32
Total interest-bearing funds	293,543	1,901	0.65	239,723	2,005	0.84	220,954	2,017	0.91
Noninterest-bearing deposits	86,727			74,431			53,040		
Other liabilities and accrued expenses	974			863			826		
Total liabilities	381,244			315,017			274,820		
Shareholders' equity	47,717			41,338			31,749		
Total liabilities & shareholders' equity	$428,961			$356,355			$306,569		
Net interest rate spread [3]		$15,810	3.75 %		$13,532	3.74 %		$12,623	4.16 %
Effect of noninterest-bearing funds			0.18			0.25			0.21
Net interest margin on earning assets [4]			3.93 %			3.98 %			4.37 %

(1) Loan fee income is included in the interest income calculation, and non-accrual loans are included in the average loan base upon which the interest rate earned on loans is calculated.

(2) Available for sale securities are presented at amortized cost

(3) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.

(4) Net interest margin represents net interest income divided by average total interest-earning assets.

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Rate/Volume Analysis

The following table presents the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The total column is further broken down to show the impact of changes in either rates or volumes. For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately, based on the changes due to rate and the changes due to volume.

	For the year ended December 31,					
	2013 vs. 2012			2012 vs. 2011		
	Due to variances in			Due to variances in		
(in thousands)	Total	Rates	Volumes [1]	Total	Rates	Volumes [1]
Interest earned on:						
Loans and leases:						
Commercial loans and leases	$202	$(407)	$ 609	$(395)	$(216)	$ (179)
Commercial real estate	1,470	(686)	2,157	1,046	(437)	1,482
Construction and land	267	(66)	332	285	94	190
Residential real estate	276	(102)	378	(85)	(56)	(28)
Consumer	(16)	10	(26)	13	(3)	16
Taxable securities	(24)	4	(28)	-	(38)	38
Federal funds sold	(1)	-	(1)	33	3	30
Total interest income	2,174	(1,248)	3,422	897	(653)	1,550
Interest paid on:						
Savings deposits	(18)	(20)	2	(19)	(17)	(1)
Checking plus interest deposits	5	(13)	18	(4)	(14)	11
Money market accounts	(35)	(98)	63	(76)	(93)	18
Time deposit $100,000 and over	(50)	(45)	(5)	57	35	22
Other time deposits	(24)	(147)	123	72	(23)	95
Short-term borrowings	(49)	(68)	19	(5)	(18)	13
Long-term borrowing	67	(6)	73	(37)	(34)	(3)
Total interest expense	(104)	(397)	293	(12)	(166)	154
Net interest earned	$2,278	$(851)	$ 3,129	$909	$(487)	$ 1,395

(1) Change attributed to mix (rate and volume) are included in volume variance

Comparison of Results of Operations

A comparison between the years ended December 31, 2013 and December 31, 2012 is presented below.

General

Net income available to common shareholders increased $791 thousand, or 78.7%, to $1.8 million for the year ended December 31, 2013 compared to net income of $1.0 million for the year ended December 31, 2012. The increase in net income available to common shareholders was primarily due to an increase in net interest income, which continued to benefit from asset growth and an overall decrease in the cost of funding, and an increase in noninterest income, partially offset by an increase in provision for credit losses and noninterest expenses. Additionally, the dividends paid on preferred stock decreased by $451 thousand for 2013 compared to 2012, due to a reduction in the dividend rate.

Interest Income

Interest income increased $2.2 million, or 14.0%, to $17.7 million for the year ended December 31, 2013 compared to $15.5 million during the year ended December 31, 2012. The increase was due to a $2.2 million, or 14.3%, increase in interest income on loans. Interest income earned on investment securities and income derived from federal funds sold relatively unchanged, decreasing $25 thousand for 2013 versus 2012. The increase in interest income on loans was due to a $70.6 million increase in average loans outstanding for 2013 versus 2012. Partially offsetting the additional revenue from the higher levels of loan balances was an overall decrease in the yield earned on the loan portfolio, as the average yield was 4.90% for 2013 compared to 5.34% during 2012.

Interest Expense

Interest expense slightly decreased $104 thousand, or 5.2%, to $1.9 million during the year ended December 31, 2013 from $2.0 million during the prior year, as a result of the average lower rates paid on interest-bearing liabilities, partially offset by an increase in the average balance of interest-bearing liabilities. Average interest bearing funds increased by $39.9 million or 19.1% for 2013 versus 2012, while the overall rates paid on these funds decreased from 84 basis points for 2012 to 65 basis points during 2013.

Net Interest Income

Net interest income is our largest source of operating revenue. Net interest income is affected by various factors including changes in interest rates and the composition of interest-earning assets and interest-bearing liabilities and maturities. Net interest income is determined by the interest rate spread (i.e., the difference between the yields earned on interest-earning assets and the rates paid on interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Net interest income increased $2.3 million, or 16.8%, during the year ended December 31, 2013 compared to the year ended December 31, 2012. The increase in net interest income was primarily due to an increase in interest income driven by our continued balance sheet growth. As noted above, the increase in net interest income was primarily due to increased interest income of $2.2 million, or 14.0%, for the year ended December 31, 2013 compared to the same period in 2012, while interest expense decreased slightly, even with the growth in deposits and borrowings.

Provision for Credit Losses

We establish a provision for credit losses, which is a charge to earnings, in order to maintain the allowance for credit losses at a level we consider adequate to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. In determining the level of the allowance for credit losses, management considers past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower’s ability to repay a loan and the levels of nonperforming loans. The amount of the allowance is based on estimates and actual losses may vary from such estimates as more information becomes available or economic conditions change. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as circumstances change as more information becomes available. The allowance for credit losses is assessed on a quarterly basis and provisions are made for credit losses as required in order to maintain the allowance.

Based on management’s evaluation of the above factors, we had a provision for credit losses of $950 thousand for 2013 compared to $718 million during 2012, an increase of $232 thousand, or 32.3%. The $950 thousand provision during 2013 includes both specific amounts for loans that are individually evaluated for impairment, and also additional general provisions for loans that are collectively evaluated, and are influenced by our continued growth in the size of the loan portfolio. The increased provision is a result of the growth in the loan portfolio during 2013.The ratio of nonperforming loans to gross loans increased slightly from 0.75% at December 31, 2012 to 0.79% at December 31, 2013. One of the Bank's primary measures of asset quality is the ratio of non-accrual loans, troubled debt restructured loans and other real estate owned ("OREO") as a percentage of total assets. This asset quality measure showed continued improvement for 2013 with a ratio of 1.11% as of December 31, 2013 compared to 1.32% at the end of 2012.

Management analyzes the allowance for credit losses as described in the section entitled "Allowance for Credit Losses." The provision that is recorded is sufficient, in management's judgment, to bring the allowance for credit losses to a level that reflects the losses inherent in our loan portfolio relative to loan mix, economic conditions and historical loss experience. Management believes, to the best of its knowledge, that all known losses as of the balance sheet dates have been recorded. However, although management uses the best information available to make determinations with respect to the provisions for credit losses, additional provisions for credit losses may be required to be established in the future should economic or other conditions change substantially. In addition, as an integral part of their examination process, the Maryland Office of the Commissioner of Financial Regulation and the FDIC will periodically review the allowance for credit losses. The Maryland Office of the Commissioner of Financial Regulation and the FDIC may require us to recognize additions to the allowance based on their analysis of information available to them at the time of their examination.

Noninterest Income

Noninterest income was $1.3 million for the year ended December 31, 2013 compared to $768 thousand for the year ended December 31, 2012. The two primary reasons for the increase in noninterest income were gain on the sales of loans and earnings derived from our BOLI program. Our heightened focus on mortgage banking activities and broadening the secondary market investor base led to revenue derived from mortgage banking activities of $215 thousand for 2013 compared to $122 thousand in 2012, primarily due to a rise in volume of residential mortgage loans originated and sold. In addition, the Bank initiated a BOLI program in January 2013 that generated $282 thousand of income during 2013; there was no such income in 2012.

Service charges on deposit accounts, which consist of account activity fees such as overdraft fees and other traditional banking fees, increased $65 thousand or 20% during 2013. This increase was due mainly to an increase in overdraft or non-sufficient fees as more customer checks were presented where the funds were insufficient to cover the amount of the check.

Sales of other real estate owned resulted in a net loss of $37 thousand on the sale of one property held in OREO for 2013, compared to a net loss of $131 thousand on the sales of similar properties during 2012. This year over year decrease in the loss recognized resulted in a year over year improvement in noninterest income of $94 thousand.

Other operating income, which includes certain loan fees and various transaction-related fees such as wire transfer fees, interchange fees resulting from debit card transactions and ATM usage fees, increased $22 thousand or 4.8% as a result of increased customer activity during 2013 compared to 2012. The increase was primarily due to our having a larger base of deposit customers and balances during 2013, which is the primary source of these transaction related revenues.

Noninterest Expenses

Noninterest expenses increased $2.4 million or 22.3%, to $13.2 million for the year ended December 31, 2013 compared to the $10.8 million for the year ended December 31, 2012. More than half of this increase in expenditures was in compensation and benefits expenses, which increased by $1.3 million or 21.8% for 2013 versus 2012. During 2013 the Bank expanded its mortgage banking team including a highly seasoned executive management member and also additional business development officers focused on our expansion through the greater Baltimore market, in addition to expanded operational, compliance and administrative support staff. We also increased staff during 2013 as we added one branch via acquisition and opened another branch location in Towson, Maryland. In addition to the increased compensation expenses resulting from our increased staff, benefits also increased $293 thousand or 24.3% for 2013 over 2012, partially due to the payroll taxes on the higher number of staff and also due to an increase of $126 thousand or 18.5% in the cost of providing medical insurance.

Occupancy and equipment expenses during 2013 increased $82 thousand or 5.5% from the prior year due to both increases in rental payments for our existing facilities and the incremental costs of operating additional locations as we continue to expand our presence in the markets we serve. As the Bank continues its Baltimore expansion we expect to see these costs increase.

Marketing and business development expenses during 2013 increased $145 thousand or 23.4% over the prior year to support sales growth and research initiatives in conjunction with ongoing internal growth activities and also our strategic growth initiatives.

Professional fees primarily consist of legal, accounting and consulting expenses, increased $348 thousand or 65.1% during 2013 compared to the prior year. This increase was primarily from legal and investment banking fees for the branch acquisition consummated in 2013, and ongoing strategic growth initiatives as mentioned above.

Provision for other real estate owned increased nearly $300 thousand due to a lower valuation on one of our foreclosed properties held. Expenses related to the ongoing maintenance and real estate taxes on these properties decreased slightly for 2013 compared to 2012.

Other operating expensed consists mainly of loan related expenses (including collection costs associated with non-performing assets), and a variety of general expenses such as telephone and data lines, supplies and postage and courier services. In aggregate, these expenses increased $89 thousand or 6.9% year over year. Generally, we have experienced a decline in the costs relating to loan collection activities, as our asset quality has improved, while we have recorded increases in the general expense categories mentioned above due to our growth in staff levels, locations, and customer base.

Income Tax Expense

Taking into consideration the above-stated changes in net interest income, the provision for credit losses, our noninterest income and noninterest expense levels, pretax income increased by $186 thousand or 6.7% from $2.8 million in 2012 to $2.9 million in 2013. Income tax expense amounted to $984 thousand for year ended December 31, 2013 and $1.1 million for the year ended December 31, 2012, resulting in effective tax rates of 33.4% and 41.3%, respectively. The effective tax rate is influenced sources of non-taxable income, such as the income from our BOLI program, and also by certain non-deductible expense items relative to pre-tax income.

Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011 is presented below:

General

Net income available to common shareholders increased $71 thousand, or 7.6%, to $1.0 million for the year ended December 31, 2012 compared to net income of $934 thousand for the same period in 2011. The increase in net income available to common shareholders was primarily due to an increase in net interest income which continued to benefit from overall decreases in the cost of funding and a reduction in the provision for credit losses, partially offset by a decrease in noninterest income and an increase in noninterest expenses.

Interest Income

Interest income increased $897 thousand, or 6.1%, to $15.5 million for the year ended December 31, 2012 compared to $14.6 million during the same period in 2011. The increase was primarily due to an $864 thousand, or 6.0%, increase in interest income on loans. Interest income earned on investment securities remained unchanged year over year, while income derived from federal funds sold increased $33 thousand over the same period. The increase in interest income on loans was due to a $27.2 million increase in average loans outstanding for 2012 versus 2011. Partially offsetting the increased revenue from the higher levels of loans was a decrease in the yields earned on the loan portfolio, as the average yield was 5.34% for 2012 compared to 5.57% during 2011.

Interest Expense

Interest expense slightly decreased $12 thousand, or less than 1.0%, totaling $2.0 million for both the years ended December 31, 2012 and December 31, 2011. Even though average interest bearing funds increased by $18.8 million or 8.5% for 2012 versus 2011, the overall rates paid on these funds decreased from 91 basis points for 2011 to 84 basis points during 2012.

Net Interest Income

Net interest income increased $909 thousand, or 7.2%, during the year ended December 31, 2012 compared to the same period in 2011. The increase in net interest income was primarily due to an increase in interest income driven by our continued balance sheet growth. As noted above, the increase in net interest income was primarily due to increased interest income of $897 thousand, or 6.1%, for the year ended December 31, 2012 compared to the same period in 2011, while interest expense remained essentially unchanged, even with the growth in deposits and borrowings.

Provision for Credit Losses

We had a provision for credit losses of $718 thousand for the 2012 year compared to $1.2 million during 2011, a reduction of $446 thousand, or 38.3%. The $718 thousand provision during 2012 reflects both an improvement in the number and amount of nonperforming loans, as the ratio of nonperforming loans to total loans decreased from 2.13% at December 31, 2011 to 0.72% at December 31, 2012, as well as the additional general provisions that are required given our continued growth in the size of the loan portfolio. One of the Bank's primary measures of asset quality is the ratio of non-accrual loans, troubled debt restructured loans and OREO as a percentage of total assets. This asset quality measure showed improvement for 2012 with a ratio of 1.32% as of December 31, 2012 compared to 2.40% at the end of 2011.

Noninterest Income

Noninterest income was $768 thousand for the year ended December 31, 2012 compared to $1.1 million for the year ended December 31, 2011. Service charges on deposit accounts, which consist of account activity fees such as overdraft fees and other traditional banking fees, increased $24 thousand during 2012. This increase of 8.1% is due mainly to a $31 thousand or 35.4% increase in service fees, including analysis charges resulting from the growth in both the number of customer accounts and in the balances of the deposits subject to these fees. Partially offsetting this increase was a decrease in overdraft or non-sufficient fees of $23 thousand or 8.1% as there were less customer checks presented where the funds were insufficient to cover the amount of the check.

The Bank began selling mortgage loans into the secondary market during 2010. The gains on sales of loans income derived from these activities increased $94 thousand or 334.1% from $28 thousand in 2011 to $122 thousand for 2012, primarily related to a rise in volume of loans originated and sold.

Other operating income increased $103 thousand or 29.2% due to increased customer activity during 2012 compared to 2011. Included in the increase for 2012 was a $49.9 thousand one time pre-payment penalty collected on one commercial credit relationship.

Sales of other real estate owned resulted in a net loss of $131 thousand on the sale of one property held in OREO for 2012, compared to net gains of $459 thousand on the sales of similar properties during 2011. This year over year change related to real estate sales resulted in decreased noninterest income of $590 thousand, and is the primary reason for the overall decrease in total noninterest income for 2012 compared to 2011.

Noninterest Expenses

Noninterest expenses increased $675 thousand or 6.7%, to $10.8 million for the year ended December 31, 2012 compared to the $10.1 million for the year ended December 31, 2011. The largest area of increase in expenditures was in our compensation and benefits, which increased by $1.1 million or 21% for 2012 versus 2011. Compensation costs increased by $830 thousand or 20.5% primarily from the increase in the number of associates that we employ as we continue to grow both in size as well as in locations. This increase also included the commissions paid to mortgage loan originators, which corresponds to the increases in revenues in our mortgage banking activities. Taxes and benefits also increased $225 thousand or 23.0% for 2012 over 2011, partially due to the higher number of staff, but also due to an increase of $153 thousand or 29% in the cost of providing medical insurance.

Occupancy expenses increased $73 thousand or 5.1% from the prior year due to the additional rent expense of our new branch location in Annapolis, MD, which opened in the first half of 2012, and expenses related to its start-up.

Marketing and business development expenses increased $112 thousand or 22.7% over the prior year to support sales growth and research initiatives in conjunction with ongoing internal growth activities and also our strategic growth initiatives. Professional fees consist primarily of legal, accounting and consulting expenses, increased $134 thousand or 33.4% over the prior year from legal and investment banking fees for ongoing strategic growth initiatives, and also organizational and SEC registration matters.

Data Processing fees increased by $98 thousand or 27.8% for 2012 versus 2011 mostly related to the increase in the number of customers and also the introduction of new services such as electronic statements and mobile banking. FDIC assessments decreased $22 thousand or 6.6% in 2012 compared to 2011 primarily due to changes in the assessment base and rate calculation as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Provision for other real estate owned decreased $729 thousand or 93.8% due to lower operating costs of foreclosed properties and a stabilization of the valuations on the properties held as OREO.

Other operating expensed consists mainly of loan related expenses (including collection costs associated with non-performing assets), and a variety of general expenses such as phone and data lines, supplies and postage and courier services. These expenses decreased slightly, 3.4%. year over year.

Income Tax Expense

Taking into consideration the above stated changes in net interest income, the provision for credit losses, our noninterest income and noninterest expense levels, pretax income increased by $311 thousand or 12.7% from $2.5 million in 2011 to $2.8 million in 2012. Income tax expense amounted to $1.1 million for both the years ended December 31, 2012 and 2011, resulting in effective tax rates of 41.3% and 40.4%, respectively. The effective tax rate is influenced by certain non-deductible expense items relative to pre-tax income.

Nonperforming and Problem Assets

Management performs reviews of all delinquent loans and our loan officers contact customers to attempt to resolve potential credit issues in a timely manner. When in the best interests of Howard Bank and the customer, we will do a troubled debt restructure with respect to a particular loan. When not possible, we seek to aggressively move loans through the legal and foreclosure process within applicable legal constraints.

Loans are placed on non-accrual status when payment of principal or interest is 90 days or more past due and the value of the collateral securing the loan, if any, is less than the outstanding balance of the loan. Loans are also placed on non-accrual status if management has serious doubt about further collectability of principal or interest on the loan, even though the loan is currently performing. When loans are placed on a non-accrual status, unpaid accrued interest is fully reversed, and further income is recognized only to the extent received. The loan may be returned to accrual status if the loan is brought current, has performed in accordance with the contractual terms for a reasonable period of time and ultimate collectability of the total contractual principal and interest is no longer in doubt.

The table below sets forth the amounts and categories of our nonperforming assets, which consist of non-accrual loans, troubled debt restructurings and OREO (which includes real estate acquired through, or in lieu of, foreclosure), at the dates indicated.

	December 31,				
(in thousands)	2013	2012	2011	2010	2009
Non-accrual loans:					
Real estate loans:					
Construction and land	$-	$432	$-	$-	$-
Residential - First Lien	331	442	368	-	40
Residential - Junior Lien	-	-	44		
Commercial	258	384	1,988	3,601	3,391
Commercial and leases	2,593	1,143	3,229	1,764	1,454
Consumer	-	-	9	-	-
Total non-accrual loans	3,182	2,401	5,638	5,365	4,885
Troubled debt restructure loans:					
Real estate loans:					
Commercial	-	-	-	-	2,765
Residential - First Lien	-	-	240	-	-
Commercial	-	-	-	285	-
Total troubled debt restructure loans	-	-	240	285	2,765
Total non-performing loans	3,182	2,401	5,878	5,650	7,650
Other real estate owned:					
Land	595	595	595	877	839
Commercial	1,782	2,130	1,084	1,941	-
Residential	-	178	206	206	-
Total other real estate owned	2,377	2,903	1,885	3,024	839
Total non-performing assets	$5,559	$5,304	$7,763	$8,674	$8,489
Ratios:					
Non-performing loans to total gross loans	0.79 %	0.72 %	2.13 %	2.20 %	3.03 %
Non-performing assets to total assets	1.11 %	1.32 %	2.40 %	2.89 %	2.97 %

Included in total non-accrual loans at December 31, 2013 above are six troubled debt restructured (“TDR”) loans totaling $861 thousand that were not performing in accordance with the modified terms, and the accrual of interest has ceased. These TDRs are commercial loans that represent one relationship. Loans 90 days or more past due and still accruing interest at December 31, 2013 consisted of one commercial real estate loan with a balance of $159 thousand and one commercial loan with a balance of $297 thousand.

Interest income that would have been recorded during the year ended December 31, 2013, 2012 and 2011 if non-accrual loans had been current and in accordance with their original terms was $116 thousand, $113 thousand and $105 thousand, respectively. No interest income was recorded on such loans during these periods.

Under accounting principles generally accepted in the United States of America, we are required to account for certain loan modifications or restructurings as “troubled debt restructurings.” In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if Howard Bank, for economic or legal reasons related to the borrower’s financial difficulties, grants a concession, such as a reduction in the effective interest rate, to the borrower that we would not otherwise consider. However, all debt restructurings or loan modifications for a borrower do not necessarily always constitute troubled debt restructurings.

Nonperforming assets amounted to $5.6 million or 1.11% of total assets at December 31, 2013 compared to $5.3 million or 1.32% of total assets at December 31, 2012 and $7.8 million or 2.40% of total assets at December 31, 2011. Total nonperforming assets increased by $255 thousand or 4.8% during 2013 due to a $781 thousand increase in non-accrual loans offset by a decrease in OREO of $526 thousand. The decline in OREO was related to the sale of one property (which resulted in a net loss of $37 thousand) and a valuation allowance of $347 thousand taken on another property. There were no new OREO properties added in 2013.

At December 31, 2013, our nonperforming loans consisted mainly of 20 commercial loans totaling $2.6 million, one residential mortgage totaling $331 thousand, and one commercial real estate loan totaling $258 thousand. Of the 20 commercial nonperforming loans totaling $2.4 million, ten have SBA guarantees totaling $1.6 million.

The composition of our nonperforming loans is further described below:

- Six commercial loans to a local business totaling $0.86 million. Most of these loans have an SBA guarantee, and reserves have been taken to reflect the amount expected to be received once claims are submitted to the SBA.

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- Eleven small commercial loans totaling approximately $0.30 million to borrowers that are in various stages of collection. Each relationship is independently evaluated, and no losses are anticipated from these eight loans.
- One commercial real estate loan for $0.26 million, which is guaranteed by a local business and is also secured by the assets of the business. A specific reserve has been established and based upon current valuations, no further losses are anticipated.
- Three commercial loans to one customer totaling $1.43 million, all of which carries an SBA guarantee. A settlement offer has been negotiated, no further losses are anticipated.
- One residential mortgage for $0.33 million. A specific reserve has been established and based upon current valuations, no further losses are anticipated.

Other Real Estate Owned

Real estate we acquire as a result of foreclosure is classified as OREO. When property is acquired it is recorded at the lower of cost, which is the unpaid balance of the loan plus estimated foreclosure costs, or fair value at the date of foreclosure. If there is a subsequent decline in the value of real estate owned, we provide an additional allowance to reduce real estate acquired through foreclosure to its fair value less estimated disposal costs. Costs relating to holding such real estate are charged against income in the current period while costs relating to improving such real estate are capitalized until a saleable condition is reached up to the property's net realizable value, then such costs would be charged against income in the current period. We had foreclosed real estate of $2.4 million at December 31, 2013, $2.9 million at December 31, 2012 and $1.9 million at December 31, 2011. Foreclosed real estate at December 31, 2013 consisted of two office condominiums in Prince George's County, Maryland, several parcels of unimproved land in Baltimore County, Maryland, one commercial lot in Baltimore County, Maryland, and one commercial building in Sussex County, Delaware.

Classification of Loans

Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets that are considered to be of lesser quality as Substandard, Doubtful, or Loss assets. An asset is considered Substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all of the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets that do not expose us to risk sufficient to warrant classification in one of the aforementioned categories, but which possess potential weaknesses that deserve our close attention, are required to be designated as Special Mention.

We maintain an allowance for credit losses at an amount estimated to equal all credit losses incurred in our loan portfolio that are both probable and reasonable to estimate at a balance sheet date. Our determination as to the classification of our assets is subject to review by the Maryland Commissioner of Financial Regulation and the FDIC. We regularly review our asset portfolio to determine whether any assets require classification in accordance with applicable regulations.

The following table sets forth our amounts of classified loans and criticized loans (classified loans and loans designated as Special Mention) at the dates indicated.

	December 31,		
(in thousands)	2013	2012	2011
Classified loans:			
Substandard	$3,182	$2,401	$5,881
Doubtful	-	-	-
Total classified loans	3,182	2,401	5,881
Special mention	-	-	-
Total criticized loans	$3,182	$2,401	$5,881

At December 31, 2013, total classified loans consisted of $3.2 million of non-accrual loans consisting of $2.6 million in commercial business lines and loans, $331 thousand in residential real estate, and $258 thousand in commercial real estate loans non-owner occupied. At December 31, 2012, total classified loans consisted of $2.4 million of non-accrual loans consisting of $1.2 million in commercial business lines and loans, $442 thousand in residential real estate, $384 thousand in commercial real estate loans and $432 thousand in construction and land loans.

Allowance for Credit Losses

We provide for credit losses based upon the consistent application of our documented allowance for credit loss methodology. All credit losses are charged to the allowance for credit losses and all recoveries are credited to it. Additions to the allowance for credit losses are provided by charges to income based on various factors which, in our judgment, deserve current recognition in estimating probable losses. We regularly review the loan portfolio and make provisions for credit losses in order to maintain the allowance for credit losses in accordance with accounting principles generally accepted in the United States ("GAAP"). The allowance for credit losses consists primarily of two components:

1) Specific allowances are established for loans classified as Substandard or Doubtful. For loans classified as impaired, the allowance is established when the net realizable value (collateral value less costs to sell) of the impaired loan is lower than the carrying amount of the loan. The amount of impairment provided for as a specific allowance is represented by the deficiency, if any, between the underlying collateral value and the carrying value of the loan. Impaired loans for which the estimated fair value of the loan, or the loan's observable market price or the fair value of the underlying collateral, if the loan is collateral dependent, exceeds the carrying value of the loan are not considered in establishing specific allowances for credit losses; and

2) General allowances established for credit losses on a portfolio basis for loans that do not meet the definition of impaired loans. The portfolio is grouped into similar risk characteristics, primarily loan type and regulatory classification. We apply an estimated loss rate to each loan group. The loss rates applied are based upon our loss experience adjusted, as appropriate, for the qualitative factors discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions.

The allowance for credit losses is maintained at a level to provide for losses that are probable and can be reasonably estimated. Management's periodic evaluation of the adequacy of the allowance is based on Howard Bank's past credit loss experience, known and inherent losses in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

A loan is considered past due or delinquent when a contractual payment is not paid on the day it is due. A loan is considered impaired when, based on current information and events, it is probable that Howard Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. 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, 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. The impairment of a loan may be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided by the collateral. Generally, Howard Bank's impairment on such loans is measured by reference to the fair value of the collateral. Interest income on impaired loans is recognized on the cash basis.

Our loan policies state that after all collection efforts have been exhausted, and the loan is deemed to be a loss, then the remaining loan balance will be charged to the established allowance for credit losses. All loans are evaluated for loss potential once it has been determined by the Watch Committee that the likelihood of repayment is in doubt. When a loan is past due for at least 90 days or a deterioration in debt service coverage ratio, guarantor liquidity, or loan-to-value ratio has occurred that would cause concern regarding the likelihood of the full repayment of principal and interest, and the loan is deemed not to be well secured, the loan should be moved to non-accrual status and a specific reserve is established if the net realizable value is less than the principal value of the loan balance(s). Once the actual loss value has been determined a charge-off against the allowance for credit losses for the amount of the loss is taken. Each loss is evaluated on its specific facts regarding the appropriate timing to recognize the loss.

The adjustments to historical loss experience are based on our evaluation of several qualitative factors, including:

- changes in lending policies, procedures, practices or personnel;
- changes in the level and composition of construction portfolio and related risks;
- changes and migration of classified assets;
- changes in exposure to subordinate collateral lien positions;
- levels and composition of existing guarantees on loans by SBA or other agencies;
- changes in national, state and local economic trends and business conditions;
- changes and trends in levels of loan payment delinquencies; and

- any other factors that management considers relevant to the quality or performance of the loan portfolio.

We evaluate the allowance for credit losses based upon the combined total of the specific and general components. Generally when the loan portfolio increases, absent other factors, the allowance for credit loss methodology results in a higher dollar amount of estimated probable losses than would be the case without the increase. Generally when the loan portfolio decreases, absent other factors, the allowance for credit loss methodology results in a lower dollar amount of estimated probable losses than would be the case without the decrease.

Commercial and commercial real estate loans generally have greater credit risks compared to the one- to four-family residential mortgage loans we originate, as they typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment experience on loans secured by income-producing properties typically depends on the successful operation of the related business and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy. Actual credit losses may be significantly more than the allowance for credit losses we have established, which could have a material negative effect on our financial results.

Generally, we underwrite commercial loans based on cash flow and business history and receive personal guarantees from the borrowers where appropriate. We generally underwrite commercial real estate loans and residential real estate loans at a loan-to-value ratio of 85% or less. Accordingly, in the event that a loan becomes past due and, randomly with respect to performing loans, we will conduct visual inspections of collateral properties and/or review publicly available information, such as online databases, to ascertain property values. We will also obtain formal appraisals on a regular basis even if we are not considering liquidation of the property to repay a loan. It is our practice to obtain updated appraisals if there is a material change in market conditions or if we become aware of new or additional facts that indicate a potential material reduction in the value of any individual property collateral.

For impaired loans, we utilize the appraised value in determining the appropriate specific allowance for credit losses attributable to a loan. In addition, changes in the appraised value of multiple properties securing our loans may result in an increase or decrease in our general allowance for credit losses as an adjustment to our historical loss experience due to qualitative and environmental factors, as described above.

As of December 31, 2013 and 2012, nonperforming loans amounted to $3.2 million and $2.4 million, respectively. The amount of nonperforming loans requiring specific reserves totaled $1.3 million and $1.8 million, respectively, and the amount of nonperforming loans with no specific valuation allowance totaled $1.9 million at December 31, 2013 and $0.6 million at December 31, 2012.

Nonperforming loans are evaluated and valued at the time the loan is identified as impaired on a case by case basis, at the lower of cost or market value. Market value is measured based on the value of the collateral securing the loan. The value of real estate collateral is determined based on an appraisal by qualified licensed appraisers hired by us. Appraised values may be discounted based on management's historical experience, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. The difference between the appraised value and the principal balance of the loan will determine the specific allowance valuation required for the loan, if any. Nonperforming loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

We evaluate the loan portfolio on at least a quarterly basis, more frequently if conditions warrant, and the allowance is adjusted accordingly. While we use the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the Maryland Office of the Commissioner of Financial Regulation and the FDIC will periodically review the allowance for credit losses. The Maryland Office of the Commissioner of Financial Regulation and the FDIC may require us to recognize additions to the allowance based on their analysis of information available to them at the time of their examination.

The following table sets forth activity in our allowance for credit losses for the twelve months ended:

	December 31,				
(in thousands)	2013	2012	2011	2010	2009
Balance at beginning of year	$2,764	$3,433	$3,523	$3,508	$2,659
Charge-offs:					
Real estate					
Construction and land loans	-	-	-	-	-
Residential first lien loans	(183)	(79)	-	-	-
Residential junior lien loans	-	(44)	-	(40)	-
Commercial owner occupied laons	-	-	(1,033)	-	-
Commercial non-owner occupied loans	(375)	(268)	-	(100)	-
Commercial loans and leases	(759)	(1,129)	(562)	(1,585)	(2,818)
Consumer loans	-	(15)	(21)	(29)	(13)
	(1,317)	(1,535)	(1,616)	(1,754)	(2,831)
Recoveries:					
Real estate					
Construction and land loans	-	-	-	-	-
Residential first lien loans	-	-	-	-	-
Residential junior lien loans	-	-	-	-	-
Commercial owner occupied laons	-	-	-	-	-
Commercial non-owner occupied loans	29	63	-	-	-
Commercial loans and leases	80	80	361	135	2
Consumer loans	-	5	1	1	8
	109	148	362	136	10
Net recoveries (charge-offs)	(1,208)	(1,387)	(1,254)	(1,618)	(2,821)
Provision for credit losses	950	718	1,164	1,633	3,670
Balance at end of year	$2,506	$2,764	$3,433	$3,523	$3,508
Net charge-offs to average loans and leases	0.34 %	0.48 %	0.48 %	0.63 %	1.23 %

Allocation of Allowance for Credit Losses

The following tables set forth the allowance for credit losses allocated by loan category and the percent of loans in each category to total loans at the dates indicated. The allowance for credit losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

December 31,

(dollars in thousands)	2013 Amount	**Percent 1**		2012 Amount	Percent 1		2011 Amount	Percent 1		2010 Amount	Percent1		2009 Amount	Percent1	
Real estate															
Construction and land loans	$122	12.6	%	$127	11.8	%	$174	14.2	%	$143	11.9	%	$515	13.2	%
Residential first lien loans	200	9.7		204	9.2		111	8.0		16	9.1		30	8.0	
Residential junior lien loans	34	2.0		22	2.5		64	3.3		20	3.8		26	4.1	
Commercial owner occupied laons	131	22.4		650	19.0		611	16.8		892	18.2		903	17.2	
Commercial non-owner occupied loans	541	28.1		505	29.8		197	27.8		124	22.7		358	20.3	
Commercial loans and leases	1,464	24.9		1,227	27.3		2,233	29.4		2,294	33.8		1,658	36.7	
Consumer loans	14	0.3		29	0.4		43	0.5		34	0.5		18	0.5	
Total	$2,506	100.0	%	$2,764	100.0	%	$3,433	100.0	%	$3,523	100.0	%	$3,508	100.0	%

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

We measure the historic loss performance based upon the levels of losses incurred in each preceding 24-month period. As is shown in a table above, reflecting the amount of charge-offs per segment, except for one year, commercial loans has been the category with the most credit losses, and thus the allocation of the total allowance at December 31, 2013 reflects this historic loss experience.

Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, loan repayments, advances from the FHLB, principal repayments and the sale of securities available for sale. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. Our Asset/Liability Committee is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of December 31, 2013 and December 31, 2012.

We regularly monitor and adjust our investments in liquid assets based upon our assessment of:

- Expected loan demand;
- Expected deposit flows and borrowing maturities;
- Yields available on interest-earning deposits and securities; and
- The objectives of our asset/liability management program.

Excess liquid assets are invested generally in interest-earning deposits and short-term securities.

The most liquid of all assets are cash and cash equivalents. The level of these assets is dependent on our operating, financing, lending and investing activities during any given period. At December 31, 2013 and 2012, cash and cash equivalents totaled $35.7 million and $36.4 million, respectively. The decrease for 2013 primarily resulted from the growth in our total loans and the purchase of BOLI outpacing the growth in our deposits and other sources of funds. We used cash and cash equivalents to provide additional funds needed to fund these assets.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our statements of cash flows included in our financial statements.

At December 31, 2013 and 2012, we had $75.8 million and $74.6 million, respectively, in loan commitments outstanding, including commitments issued to originate loans of $34.5 million and $34.1 million at December 31, 2013 and 2012, respectively, and $41.3 million and $40.5 million in unused lines of credit to borrowers at December 31, 2013 and 2012, respectively. In addition to commitments to originate loans and unused line of credits we had $9.7 million and $6.2 million in letters of credit at December 31, 2013 and 2012, respectively. Certificates of deposit due within one year totaled $97.4 million, or 25.0% of total deposits, and $74.7 million, or $23.7% of total deposits, at December 31, 2013 and 2012, respectively. If these deposits do not remain with us, we may be required to seek other sources of funds, including loan and securities sales, and FHLB advances. Depending on market conditions, we may be required to pay higher rates on our deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2014. We believe, however, based on historical experience and current market interest rates that we will retain upon maturity a large portion of our certificates of deposit with maturities of one year or less as of December 31, 2013.

Our primary investing activity is originating loans. During the years ended December 31, 2013 and December 31, 2012, cash used to fund net loan growth was $45.7 million and $48.8 million, respectively. During these periods, we purchased $50.5 million and $47.0 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts and FHLB advances. We experienced a net increase in deposits of $38.8 million and $52.2 million, respectively, during the years ended December 31, 2013 and 2012. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLB, which provide an additional source of funds. FHLB advances increased to $40 million in 2013 compared to $22 million in 2012. At December 31, 2013, we had the ability to borrow up to a total of $93.3 million based upon our credit availability at the FHLB, subject to collateral requirements.

The Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At December 31, 2013 and 2012, the Bank exceeded all regulatory capital requirements. The Bank is considered "well capitalized" under regulatory guidelines. See— "Item 1. Business—Supervision and Regulation—Howard Bank—Banking Regulation—Capital Requiremen and the Notes to our Financial Statements.

Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements

We are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of our customers. These financial instruments are limited to commitments to originate loans and involve, to varying degrees, elements of credit, interest rate, and liquidity risk. These do not represent unusual risks, and management does not anticipate any losses that would have a material effect on us.

Outstanding loan commitments and lines of credit at December 31, 2013 and December 31, 2012 are as follows:

	December 31,	
(in thousands)	2013	2012
Unfunded loan commitments	$34,464	$34,057
Unused lines of credit	41,326	40,493
Letters of credit	9,676	6,178

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. We generally require collateral to support financial instruments with credit risk on the same basis as we do for balance sheet instruments. Management generally bases the collateral required on the credit evaluation of the counterparty. Commitments generally have interest rates at current market rates, expiration dates or other termination clauses and may require payment of a fee. Available credit lines represent the unused portion of lines of credit previously extended and available to the customer so long as there is no violation of any contractual condition. These lines generally have variable interest rates. Since we expect many of the commitments to expire without being drawn upon, and since it is unlikely that all customers will draw upon their lines of credit in full at any one time, the total commitment amount or line of credit amount does not necessarily represent future cash requirements. We evaluate each customer's credit-worthiness on a case-by-case basis. Because we conservatively underwrite these facilities at inception, we have not had to withdraw any commitments. We are not aware of any loss that we would incur by funding our commitments, lines of credit or letters of credit.

The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount has been recognized in the statement of financial condition at December 31, 2013, December 31, 2012 or December 31, 2011 as a liability for credit loss related to these commitments.

Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") issued

ASU No. 2014-4, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).* The guidance clarifies when an "in substance repossession or foreclosure" occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, such that all or a portion of the loan should be derecognized and the real estate property recognized. ASU 2014-04 states that a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments of ASU 2014-04 also require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The amendments of ASU 2014-04 are effective for interim and annual periods beginning after December 15, 2014, and may be applied using either a modified retrospective transition method or a prospective transition method as described in ASU 2014-04. The Company will evaluate this amendment but does not believe they will have an impact on its financial position or results of operations.

ASU No. 2013-02, *Comprehensive Income (Topic 220) – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU No. 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Company on January 1, 2013 and did not have a significant impact on the Company's financial statements

Impact of Inflation and Changing Prices

Our financial statements and related notes have been prepared in accordance with U.S. GAAP. U.S. GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration of changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than the effects of inflation.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not required as the Company is a smaller reporting company.

Part II

Item 8. Financial Statements and Supplementary Data

Report if Independent Registered Public Accounting Firm

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
Howard Bancorp, Inc.

Ellicott City, Maryland

We have audited the accompanying consolidated balance sheets of Howard Bancorp, Inc., (the "Company") as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of their internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Howard Bancorp, Inc. as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

Baltimore, Maryland March 27, 2014

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Howard Bancorp, Inc. and Subsidiary

Consolidated Balance Sheets

(in thousands)	December 31, 2013	December 31, 2012
ASSETS		
Cash and due from banks	$ 23,282	$ 25,739
Federal funds sold	12,454	10,622
Total cash and cash equivalents	35,736	36,361
Securities available-for-sale	28,688	26,875
Nonmarketable equity securities	2,282	1,475
Loans held for sale	3,298	1,639
Loans and leases, net of unearned income	403,875	322,218
Allowance for credit losses	(2,506)	(2,764)
Net loans and leases	401,369	319,454
Bank premises and equipment, net	10,842	9,573
Core deposit intangible	342	-
Bank owned life insurance	11,282	-
Other real estate owned	2,377	2,903
Deferred income taxes	1,125	1,160
Interest receivable and other assets	2,577	2,235
Total assets	$ 499,918	$ 401,675
LIABILITIES		
Noninterest-bearing deposits	$ 89,759	$ 95,875
Interest-bearing deposits	299,190	218,983
Total deposits	388,949	314,858
Short-term borrowings	45,658	26,987
Long-term borrowings	16,000	12,000
Accrued expenses and other liabilities	687	1,109
Total liabilities	451,294	354,954
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preferred stock—par value $0.01 (liquidation preference of $1,000 per share) authorized 5,000,000; shares issued and outstanding 12,562 series AA at December 31, 2013 and December 31, 2012, net of issuance cost	12,562	12,562
Common stock - par value of $0.01 authorized 10,000,000 shares; issued and outstanding 4,095,650 shares at December 31, 2013 and 4,040,471 December 31, 2012	41	40
Capital surplus	37,607	37,484
Accumulated deficit	(1,590)	(3,386)
Accumulated other comprehensive income	4	21
Total shareholders’ equity	48,624	46,721
Total liabilities and shareholders’equity	$ 499,918	$ 401,675

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

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Consolidated Statements of Operations

	December 31,		
(in thousands)	2013	2012	2011
INTEREST INCOME			
Interest and fees on loans	$17,579	$15,380	$14,516
Interest and dividends on securities	78	102	102
Other interest income	54	55	22
Total interest income	17,711	15,537	14,640
INTEREST EXPENSE			
Deposits	1,656	1,778	1,748
Short-term borrowings	114	163	168
Long-term borrowings	131	64	101
Total interest expense	1,901	2,005	2,017
NET INTEREST INCOME	15,810	13,532	12,623
Provision for credit losses	950	718	1,164
Net interest income after provision for credit losses	14,860	12,814	11,459
NONINTEREST INCOME			
Service charges on deposit accounts	387	322	298
Gains on the sale of loans	215	122	28
(Loss) gain on the sale of other real estate owned	(37)	(131)	459
Income from bank owned life insurance	282	-	-
Other operating income	477	455	352
Total noninterest income	1,324	768	1,137
NONINTEREST EXPENSE			
Compensation and benefits	7,397	6,075	5,020
Occupancy and equipment	1,592	1,509	1,436
Amortization of core deposit intangible	34	-	-
Marketing and business development	752	606	494
Professional fees	883	535	401
Data processing fees	529	451	353
FDIC Assessment	327	310	332
Provision for other real estate owned	347	48	777
Other operating expense	1,378	1,289	1,335
Total noninterest expense	13,239	10,823	10,148
INCOME BEFORE INCOME TAXES	2,945	2,759	2,448
Income tax expense	984	1,138	1,063
NET INCOME	1,961	1,621	1,385
Preferred stock dividends	165	616	451
Net income available to common shareholders	$1,796	$1,005	$934
NET INCOME PER COMMON SHARE			
Basic	$0.44	$0.31	$0.35

Diluted	$0.44	$0.31	$0.35

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

Consolidated Statements of Comprehensive Income

(in thousands)	December 31, 2013	2012	2011
Net Income	$1,961	$1,621	$1,385
Other comprehensive income			
Investments available-for-sale:			
Unrealized holding (losses) gains	(27)	2	(16)
Related income tax benefit (expense)	10	(1)	6
Comprehensive income	$1,944	$1,622	$1,375

Consolidated Statements of Changes in Shareholders' Equity

(dollars in thousands, except share data)	Preferred stock	Number of shares	Common stock	Capital Surplus	Accumulated deficit	Accumulated other comprehensive gain/loss	Total
Balances at January 1, 2011	$6,272	2,636,837	$ 26	$28,285	$ (5,325)	$ 30	$29,288
Net income	-	-	-	-	1,385	-	1,385
Net unrealized loss on securities	-	-	-	-	-	(10)	(10)
Dividends paid on preferred stock	12,562	-	-	-	-	-	12,562
Issuance of series AA preferred stock	-	-	-	-	(451)	-	(451)
Repurchase of series A and series B preferred stock	(6,272)	-	-	-	-	-	(6,272)
Issuance of common stock:							
Stock awards	-	3,427	-	22	-	-	22
Stock-based compensation	-	-	-	106	-	-	106
Balances at December 31, 2011	12,562	2,640,264	26	28,413	(4,391)	20	36,630
Net income	-	-	-	-	1,621	-	1,621
Net unrealized loss on securities	-	-	-	-	-	1	1
Dividends paid on preferred stock	-	-	-	-	(616)	-	(616)
Issuance of common stock:							
Stock offering	-	1,396,364	14	8,966	-	-	8,980
Stock awards	-	3,843	-	22	-	-	22
Stock-based compensation	-	-	-	83	-	-	83
Balances at December 31, 2012	12,562	4,040,471	40	37,484	(3,386)	21	46,721
Net income	-	-	-	-	1,961	-	1,961
Net unrealized gain on securities	-	-	-	-	-	(17)	(17)
Dividends paid on preferred stock	-	-	-	-	(165)	-	(165)
Issuance of common stock:							
Stock awards	-	5,179	-	37	-	-	37
Stock-based compensation	-	50,000	1	86	-	-	87
Balances at December 31, 2013	$12,562	4,095,650	$ 41	$37,607	$ (1,590)	$ 4	$48,624

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

Consolidated Statements of Cash Flows

	Years Ended December 31,		
(in thousands)	2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$1,961	$1,621	$1,385
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for credit losses	950	718	1,164
Deferred income taxes	45	518	991
Provision for other real estate owned	347	48	777
Depreciation	599	523	455
Stock-based compensation	124	105	128
Net accretion of investment securities	17	42	181
Net amortization of intangible asset	34	-	-
Loans originated for sale	(14,119)	(10,777)	(3,298)
Proceeds from loans originated for sale	12,674	9,907	3,744
Gains on sales of loans	(215)	(122)	(28)
Loss (gain) on sales of other real estate owned, net	37	131	(459)
Cash surrender value of BOLI	(282)	-	-
Increase in interest receivable	(29)	(93)	(111)
Increase (decrease) in interest payable	21	(10)	(27)
(Increase) decrease in other assets	(981)	1,092	52
(Decrease) increase in other liabilities	(443)	292	260
Net cash provided by operating activities	740	3,995	5,214
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of investment securities available-for-sale	(50,513)	(47,018)	(39,185)
Proceeds from maturities of investment securities available-for-sale	48,658	33,479	40,652
Net increase in loans and leases outstanding	(45,679)	(48,799)	(23,283)
Purchase of bank owned life insurance	(11,000)	-	-
Proceeds from the sale of other real estate owned	141	527	2,626
Purchase of premises and equipment	(1,033)	(612)	(700)
Branch acqusition (net of cash received)	(3,195)	-	-
Net cash used in investing activities	(62,621)	(62,423)	(19,890)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net (decrease) increase in noninterest-bearing deposits	(6,115)	33,831	13,365
Net increase in interest-bearing deposits	44,866	18,385	9,963
Net increase (decrease) in short-term borrowings	18,670	14,004	(12,040)
Proceeds from issuance of long-term debt	12,000	2,000	4,000
Repayment of long-term debt	(8,000)	-	-
Net proceeds from issuance of common stock, net of cost	-	8,980	-
Net proceeds from issuance of preferred stock, net of cost	-	-	6,290
Cash dividends on preferred stock	(165)	(616)	(451)
Net cash provided by financing activities	61,256	76,584	21,127
Net (decrease) increase in cash and cash equivalents	(625)	18,156	6,451

Cash and cash equivalents at beginning of period	36,361	18,205	11,754
Cash and cash equivalents at end of period	$35,736	$36,361	$18,205
SUPPLEMENTAL INFORMATION			
Cash payments for interest	$1,879	$2,015	$1,774
Cash payments for income taxes	707	490	330
Transferred from loans to other real estate owned	-	1,598	1,805
BRANCH PURCHASE			
Tangible assets acquired (net of cash received)	$38,159	$-	$-
Identifiable intangible assets acquired	376	-	-
Liabilities assumed	35,340	-	-

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

Notes to Consolidated Financial Statements

Note 1: Summary of Significant Accounting Policies

Nature of Operations

On December 15, 2005, Howard Bancorp, Inc. (“Bancorp”) acquired all of the stock and became the holding company of Howard Bank (the “Bank”) pursuant to the Plan of Reorganization approved by the shareholders of the Bank and by federal and state regulatory agencies. Each share of the Bank’s common stock was converted into two shares of Bancorp common stock effected by the filing of Articles of Exchange on that date, and the shareholders of the Bank became the shareholders of Bancorp. The Bank has four subsidiaries, three of which hold foreclosed real estate and the other owns and manages real estate that is used as a branch location and has office and retail space. The accompanying consolidated financial statements of Bancorp and its wholly-owned subsidiary bank (collectively the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

Bancorp was incorporated in April of 2005 under the laws of the State of Maryland and is a bank holding company registered under the Bank Holding Company Act of 1956. Bancorp is a single bank holding company with one subsidiary, Howard Bank, which operates as a state trust company with commercial banking powers regulated by the Maryland Division of Financial Regulation.

The Company is a diversified financial services company providing commercial banking, mortgage banking and consumer finance through banking branches, the internet and other distribution channels to businesses, business owners, professionals and other consumers located primarily in the Greater Baltimore Metropolitan Area.

The following is a description of the Company’s significant accounting policies.

Principles of Consolidation

The consolidated financial statements include the accounts of Bancorp, its subsidiary bank and the Bank’s subsidiaries. All significant intercompany accounts and transactions have been eliminated. The parent company only financial statements report investments in the subsidiary bank under the equity method. Certain reclassifications may have been made to the prior year's consolidated financial statements to conform to current period presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near-term relate to the determination of the allowance for credit losses, other-than-temporary impairment of investment securities and deferred income taxes.

Segment Information

The Company has one reportable segment, "Community Banking." All of the Company's activities are interrelated, and each activity is dependent and assessed based on how each of the activities of the Company supports the others. For example, lending is dependent upon the ability of the Bank to fund itself with deposits and other borrowings and manage interest rate and credit risk. Accordingly, all significant operating decisions are based upon analysis of the Company as one segment or unit.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, amounts due from banks, cash items in the process of clearing, federal funds sold, and interest-bearing deposits with banks with original maturities of less than 90 days. Generally, federal funds are sold as overnight investments.

Investment Securities

Marketable equity securities and debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are acquired as part of the Bank's asset/liability management strategy and may be sold in response to changes in interest rates, loan demand, changes in prepayment risk and other factors. Securities available-for-sale are carried at estimated fair value, with unrealized gains or losses based on the difference between amortized cost and fair value reported as accumulated other comprehensive income (loss), net of deferred taxes, a separate component of shareholders' equity, when appropriate. Realized gains and losses, using the specific identification method, are included as a separate component of noninterest income. Related interest and dividends are included in interest income. Declines in the fair value of individual available-for-sale securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or that management would not have the intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value or that management would be required to sell the security before recovery in fair value.

Nonmarketable Equity Securities

Nonmarketable equity securities include equity securities that are not publicly traded or are held to meet regulatory requirements such as Federal Home Loan Bank stock. These securities are accounted for at cost.

Loans Held-For-Sale

The Company engages in sales of residential mortgage loans originated by the Bank. Loans held for sale are carried at the lower of aggregate cost or fair value. Fair value is derived from secondary market quotations for similar instruments. Gains and losses on sales of these loans are recorded as a component of noninterest income in the Consolidated Statements of Operations. The Company's current practice is to sell residential mortgage loans on a servicing released basis, and, therefore, it has no intangible asset recorded for the value of such servicing.

The Company enters into commitments to originate residential mortgage loans whereby the interest rate on the loan is determined prior to funding (i.e. rate lock commitment). Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Company commits to sell a loan at a premium at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to losses nor will it realize gains related to its rate lock commitments due to changes in interest rates.

The market value of rate lock commitments and best efforts contracts are not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded. Because of the high correlation between rate lock commitments and best efforts contracts, no gain or loss occurs on rate lock commitments.

Loans and Leases

Loans are stated at their principal balance outstanding, plus deferred origination costs, less unearned discounts and deferred origination fees. Interest on loans is credited to income based on the principal amounts outstanding. Origination fees and costs are amortized to income over the contractual life of the related loans. Generally, accrual of interest on a loan is discontinued when the loan is delinquent more than 90 days unless the collateral securing the loan is sufficient to liquidate the loan. All interest accrued but not collected for loans that are placed on non-accrual or charged-off is reversed against interest income. 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 principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Management considers loans impaired when, based on current information, it is probable that the Company will not collect all principal and interest payments according to contractual terms. Loans are tested for impairment no later than when principal or interest payments become 90 days or more past due and they are placed on non-accrual. Management also considers the financial condition of the borrower, cash flows of the loan and the value of the related collateral. Impaired loans do not include large groups of smaller balance homogeneous loans such as residential real estate and consumer installment loans which are evaluated collectively for impairment. Loans specifically reviewed for impairment are not considered impaired during periods of "minimal delay" in payment (90 days or less) provided eventual collection of all amounts due is expected. The impairment of a loan may be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided by the collateral. Generally, the Company's impairment on such loans is measured by reference to the fair value of the collateral. Interest income on impaired loans is recognized on the cash basis.

The segments of the Company's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The commercial real estate ("CRE") loan segment is further disaggregated into two classes; owner occupied loans and non-owner occupied loans. Non-owner occupied CRE loans, which include loans secured by non-owner occupied nonfarm nonresidential properties, generally have a greater risk profile than owner occupied CRE loans. The residential mortgage loan segment is further disaggregated into two classes: first lien mortgages and second or junior lien mortgages.

Allowance for Credit Losses

The allowance for credit losses is maintained at a level believed adequate by management to absorb probable losses inherent in the loan portfolio and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans, actual loss experience, current economic events in specific industries and geographic areas including unemployment levels and other pertinent factors including general economic conditions. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience and consideration of economic trends, all of which may be susceptible to significant change. Credit losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for credit losses is charged to operations based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

The allowance for credit losses consists of a specific component and a nonspecific component. The components of the allowance for credit losses represent an estimation done pursuant to either Financial Accounting Standards ("FASB") Accounting Standards Codification ("ASC") Topic 450 *Contingencies* or ASC Topic 310 *Receivables*. The specific component of the allowance for credit losses reflects expected losses resulting from analysis developed through credit allocations for individual loans. The credit allocations are based on a regular analysis of all loans over a fixed-dollar amount where the internal credit rating is at or below a predetermined classification. The specific component of the allowance for credit losses also includes management's determination of the amounts necessary given concentrations and changes in portfolio mix and volume.

The nonspecific portion of the allowance is determined based on management's assessment of general economic conditions, as well as economic factors in the individual markets in which the Company operates including the strength and timing of economic cycles and concerns over the effects of a prolonged economic downturn in the current cycle. This determination inherently involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in the Bank's historical loss factors used to determine the nonspecific component of the allowance, and it recognizes knowledge of the portfolio may be incomplete. The Bank's historic loss factors are based upon actual losses incurred by portfolio segment over the preceding 24-month period. In portfolio segments where no actual losses have been incurred within the most recent 24-month period, industry loss data for that portfolio segment, as provided by the FDIC, are utilized. In addition to historic loss factors, the Bank's methodology for the allowance for credit losses also incorporates other risk factors that may be inherent within the portfolio segments. For each portfolio segment, in addition to the historic loss experience experienced, the other factors that are measured and monitored in the overall determination of the allowance include:

- Changes in lending practices within the underwriting process
- Additional risk presented for construction-related loans
- Changes in levels and migration of classified loans
- Collateral lien positions for real estate-based loans

- Amount of loans with SBA guarantees and the related net exposure levels
- The current economic condition of the market and observable trends in the economy
- Level of current delinquency levels and non-performing loans with recent trends of each
- Any other factors which management believes may impose additional risk within each portfolio segment

Each of these qualitative risk factors are measured based upon data generated either internally, or in the case of economic conditions utilizing independently provided data on items such as unemployment rates, commercial real estate vacancy rates, or other market data deemed relevant to the business conditions within the markets served.

The Company's loan policies state that after all collection efforts have been exhausted, and the loan is deemed to be a loss, then the remaining loan balance will be charged to the Company's established allowance for credit losses. All loans are evaluated for loss potential once it has been determined by the Watch Committee that the likelihood of repayment is in doubt. When a loan is past due for at least 90 days or a deterioration in debt service coverage ratio, guarantor liquidity, or loan-to-value ratio has occurred that would cause concern regarding the likelihood of the full repayment of principal and interest, and the loan is deemed not to be well secured, the loan should be moved to non-accrual status and a specific reserve is established if the net realizable value is less than the principal value of the loan balance(s). Once the actual loss value has been determined a charge-off against the allowance for credit losses for the amount of the loss is taken. Each loss is evaluated on its specific facts regarding the appropriate timing to recognize the loss.

Other Real Estate Owned

Other real estate acquired through, or in lieu of, foreclosure is initially recorded at the lower of book value or fair value less estimated cost to sell at the date of acquisition, establishing a new cost basis. Revenues and expenses from operations are included in noninterest income. Additions to the valuation allowance are included in noninterest expense. Subsequent to foreclosure, valuations are periodically performed by management and an allowance for losses is established, if necessary, by a charge to operations if the carrying value of a property exceeds its estimated fair value less estimated costs to sell.

Intangible Asset

Intangible assets consist of core deposit intangibles ("CDI") acquired in branch acquisitions. CDI represent the excess of the fair value of liabilities assumed over the fair value of tangible assets acquired in branch acquisitions. These intangible assets are amortized on an accelerated basis over an original life of 10 to 15 years. The Company reviews its intangible assets yearly, or whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If such impairment is indicated, impairment is recognized by accelerating the amortization of the asset to the extent that the carrying value exceeds the estimated fair value.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method. Premises and equipment are depreciated over the useful lives of the assets, which generally range from 3 to 10 years for furniture, fixtures and equipment and 3 to 5 years for computer software and hardware. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. The costs of major renewals and betterments are capitalized, while the costs of ordinary maintenance and repairs are included in noninterest expense.

Income Taxes

The Company uses the liability method of accounting for income taxes. Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse.

As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. In addition, deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or the entire deferred tax asset will not be realized. Interest and penalties related to income tax matters are recognized in income tax expense.

The Company does not have uncertain tax positions that are deemed material, and did not recognize any adjustments for unrecognized tax benefits. The Company's policy is to recognize interest and penalties on income taxes in other non-interest expenses. The Company remains subject to examination for income tax returns for the years ending after December 31, 2009

Net Income Per Common Share

Basic net income per common share is computed by dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the year. Diluted net income per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the year including any potential dilutive effects of common stock equivalents, such as options and warrants.

Share-Based Compensation

Compensation cost is recognized for stock options issued to directors and employees. Compensation cost is measured as the fair value of these awards on their date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required service period, generally defined as the vesting period for stock option awards. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. When an award is granted to an employee who is retirement eligible, the compensation cost of these awards is recognized over the period up to the director or employee first becomes eligible to retire.

Compensation expense for non-vested common stock awards is based on the fair value of the awards, which is generally the market price of the common stock on the measurement date, which, for the Company, is the date of grant, and is recognized ratably over the service period of the award.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit. Such financial instruments are recorded in the statement of financial condition when they are funded.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on securities available for sale, are reported as a separate component of the equity section of the consolidated balance sheet, such items, along with net income, are components of comprehensive income.

Transfer of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. In certain cases, the recourse to the Bank to repurchase assets may exist but is deemed immaterial based on the specific facts and circumstances.

New Accounting Pronouncements

ASU No. 2014-4, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).* The guidance clarifies when an "in substance repossession or foreclosure" occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, such that all or a portion of the loan should be derecognized and the real estate property recognized. ASU 2014-04 states that a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments of ASU 2014-04 also require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The amendments of ASU 2014-04 are effective for interim and annual periods beginning after December 15, 2014, and may be applied using either a modified retrospective transition method or a prospective transition method as described in ASU 2014-04. The Company will evaluate this amendment but does not believe they will have an impact on its financial position or results of operations.

ASU No. 2013-02, *Comprehensive Income (Topic 220) – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU No. 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Company on January 1, 2013 and did not have a significant impact on the Company's financial statements

Note 2: Cash and Due from Banks

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. During 2013 and 2012, the Company maintained balances at the Federal Reserve (in addition to vault cash) to meet the reserve requirements as well as balances to partially compensate for services. Additionally, the Company maintained balances with the Federal Home Loan Bank and two domestic correspondents as partial compensation for services they provided to the Company.

Note 3: Investments Securities

The amortized cost and estimated fair values of investments available for sale are as follows:

(in thousands)	December 31, 2013				2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies	$28,522	$ 1	$ 2	$ 28,521	$26,526	$ 14	$ -	$ 26,540
Mortgage-backed	157	10	-	167	314	21	-	335
	$28,679	$ 11	$ 2	$ 28,688	$26,840	$ 35	$ -	$ 26,875

There have not been any individual securities with an unrealized loss position for a period greater than one year as of either December 31, 2013 or December 31, 2012. Gross unrealized losses and fair value by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2013 is as follows:

December 31, 2013 (in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government agencies	$ 15,994	$ 2	$ -	$ -	$15,994	$ 2
Mortgage-backed	-	-	-	-	-	-
	$ 15,994	$ 2	$ -	$ -	$15,994	$ 2

In 2012, gross unrealized losses less than twelve months were less than $1 thousand.

The unrealized losses that existed were a result of market changes in interest rates since the original purchase. Management systematically evaluates investment securities for other-than-temporary declines in fair value on a quarterly basis. This analysis requires management to consider various factors, which include (1) duration and magnitude of the decline in value, (2) the financial condition of the issuer or issuers and (3) structure of the security.

An impairment loss is recognized in earnings if any of the following are true: (1) the Company intends to sell the debt security; (2) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis or (3) the Company does not expect to recover the entire amortized cost basis of the security. In situations where the Company intends to sell or when it is more likely than not that the Company will be required to sell the security, the entire impairment loss must be recognized in earnings. In all other situations, only the portion of the impairment loss representing the credit loss must be recognized in earnings, with the remaining portion being recognized in shareholders' equity as a component of other comprehensive income, net of deferred tax.

The amortized cost and estimated fair values of investments available for sale by contractual maturity are shown below:

	December 31,			
(in thousands)	2013		2012	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Amounts maturing:				
One year or less	$28,522	$ 28,521	$23,536	$ 23,544
After one through five years	51	54	3,121	3,136
After five through ten years	106	113	90	96
After ten years	-	-	93	99
	$28,679	$ 28,688	$26,840	$ 26,875

There were no sales of investment securities during 2013, 2012 or 2011. At December 31, 2013 and December 31, 2012, $20.7 million and $16.6 million fair value of securities were pledged as collateral for repurchase agreements, respectively. The outstanding balance of no single issuer, except for U. S. Government and U. S. Government agency securities, exceeded ten percent of shareholders' equity at December 31, 2013.

Note 4: Nonmarketable Equity Securities

At December 31, 2013 and December 31, 2012, the Company's investment in nonmarketable equity securities consisted of Federal Home Loan Bank of Atlanta stock, which is required for continued membership, of $2.3 million and $1.5 million, respectively. These investments are carried at cost.

Note 5: Loans and Leases

The Company makes loans and leases to customers primarily in the Greater Baltimore Maryland metropolitan area, and surrounding communities. A substantial portion of the Company's loan portfolio consists of loans to businesses secured by real estate and/or other business assets.

The loan portfolio segment balances at December 31, 2013 and December 31, 2012 are presented in the following table:

	December 31,			
(in thousands)	2013	% of Total	2012	% of Total
Real estate				
Construction and land	$50,884	12.6 %	$37,963	11.8 %
Residential - first lien	39,249	9.7	29,826	9.3
Residential - junior lien	8,266	2.0	7,983	2.5
Total residential real estate	47,515	11.7	37,809	11.7
Commercial - owner occupied	90,333	22.4	61,119	19.0
Commercial - non-owner occupied	113,559	28.1	96,223	29.9
Total commercial real estate	203,892	50.5	157,342	48.8
Total real estate loans	302,291	74.8	233,114	72.3
Commercial loans and leases	100,410	24.9	87,844	27.3
Consumer	1,174	0.3	1,260	0.4
Total loans	$403,875	100.0 %	$322,218	100.0 %

The increase in the total loans above for 2013, included the purchase of approximately $37.1 million in loans resulting from our Aberdeen branch acquisition, and an unamortized net premium paid of $134 thousand.

There were $3.3 million and $1.6 million in loans held for sale at December 31, 2013 and December 31, 2012, respectively.

Portfolio Segments

The Company currently manages its credit products and the respective exposure to credit losses (credit risk) by the following specific portfolio segments (classes) which are levels at which the Company develops and documents its systematic methodology to determine the allowance for credit losses attributable to each respective portfolio segment. These segments are:

- **Commercial business loans & leases** – Commercial loans are made to provide funds for equipment and general corporate needs. Repayment of a loan primarily uses the funds obtained from the operation of the borrower's business. Commercial loans also include lines of credit that are utilized to finance a borrower's short-term credit needs and/or to finance a percentage of eligible receivables and inventory. The Company's loan portfolio also includes a small portfolio of equipment leases, which consists of leases for essential commercial equipment used by small to medium sized businesses.
- **Construction and land loans** – Commercial acquisition, development and construction loans are intended to finance the construction of commercial and residential properties and include loans for the acquisition and development of land. Construction loans represent a higher degree of risk than permanent real estate loans and may be affected by a variety of factors such as the borrower's ability to control costs and adhere to time schedules and the risk that constructed units may not be absorbed by the market within the anticipated time frame or at the anticipated price. The loan commitment on these loans often includes an interest reserve that allows the lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan.

- **Commercial owner occupied real estate loans** – Commercial owned-occupied real estate loans consist of commercial mortgage loans secured by owner occupied properties where an established banking relationship exists and involves a variety of property types to conduct the borrower's operations. The primary source of repayment for this type of loan is the cash flow from the business and is based upon the borrower's financial health and the ability of the borrower and the business to repay.
- **Commercial non-owner occupied real estate loans** – Commercial non-owner occupied loans consist of properties where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. This commercial real estate category contains mortgage loans to the developers and owners of commercial real estate where the borrower intends to operate or sell the property at a profit and use the income stream or proceeds from the sale(s) to repay the loan.
- **Consumer loans** – This category of loans includes primarily installment loans and personal lines of credit. Consumer loans include installment loans used by customers to purchase automobiles, boats and recreational vehicles.
- **Residential first lien mortgage loans** – The residential real estate category contains permanent mortgage loans principally to consumers secured by residential real estate. Residential real estate loans are evaluated for the adequacy of repayment sources at the time of approval, based upon measures including credit scores, debt-to-income ratios, and collateral values. Loans may be either conforming or non-conforming.
- **Residential junior lien mortgage loans** – This category of loans includes primarily home equity loans and lines. The home equity category consists mainly of revolving lines of credit to consumers which are secured by residential real estate. These loans are typically secured with second mortgages on the homes.

Note 6: Credit Quality Assessment

Allowance for Credit Losses

Credit risk can vary significantly as losses, as a percentage of outstanding loans, can vary widely during economic cycles and are sensitive to changing economic conditions. The amount of loss in any particular type of loan can vary depending on the purpose of the loan and the underlying collateral securing the loan. Collateral securing commercial loans can range from accounts receivable to equipment to improved or unimproved real estate depending on the purpose of the loan. Home mortgage and home equity loans and lines are typically secured by first or second liens on residential real estate. Consumer loans may be secured by personal property, such as auto loans or they may be unsecured loan products.

To control and manage credit risk, management has an internal credit process in place to determine whether credit standards are maintained along with an in-house loan administration accompanied by oversight and review procedures. The primary purpose of loan underwriting is the evaluation of specific lending risks that involves the analysis of the borrower's ability to service the debt as well as the assessment of the value of the underlying collateral. Oversight and review procedures include the monitoring of the portfolio credit quality, early identification of potential problem credits and the management of the problem credits. As part of the oversight and review process, the Company maintains an allowance for credit losses (the "allowance") to absorb estimated and probable losses in the loan and lease portfolio. The allowance is based on consistent, continuous review and evaluation of the loan and lease portfolio, along with ongoing assessments of the probable losses and problem credits in each portfolio. While portions of the allowance are attributed to specific portfolio segments, the entire allowance is available to credit losses inherent in the total loan portfolio.

The following table provides information on the activity in the allowance for credit losses by the respective loan portfolio segment for the years ended December 31, 2013 and 2012:

	December 31, 2013							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Allowance for credit losses:								
Beginning balance	$127	$204	$22	$650	$505	$1,227	$29	$2,764
Charge-offs	-	(183)	-	-	(375)	(759)	-	(1,317)
Recoveries	-	-	-	-	29	80		109
Provision for credit losses	(5)	179	12	(519)	382	916	(15)	950
Ending balance	$122	$200	$34	$131	$541	$1,464	$14	$2,506
Ending balance: individually evaluated for impairment	-	3	-	-	-	256	-	259
collectively evaluated for impairment	122	197	34	131	541	1,208	14	2,247
Loans:								
Ending balance	50,884	39,249	8,266	90,333	113,559	100,410	1,174	403,875
Ending balance: individually evaluated for impairment	-	331	-	-	2,984	2,975	-	6,290
collectively evaluated for impairment	50,884	38,918	8,266	90,333	110,575	97,435	1,174	397,585

	December 31, 2012							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Allowance for credit losses:								
Beginning balance	$174	$111	$64	$611	$197	$2,233	$43	$3,433
Charge-offs	-	(79)	(44)	-	(268)	(1,129)	(15)	(1,535)
Recoveries	-	-	-	-	63	80	5	148
Provision for credit losses	(47)	172	2	39	513	43	(4)	718
Ending balance	$127	$204	$22	$650	$505	$1,227	$29	$2,764

Ending balance: individually evaluated for impairment	21	138	-	-	148	257	-	564
collectively evaluated for impairment	106	66	22	650	357	970	29	2,200
Loans:								
Ending balance	37,963	29,826	7,983	61,119	96,223	87,844	1,260	322,218
Ending balance: individually evaluated for impairment	432	442	-	-	3,134	1,568	-	5,576
collectively evaluated for impairment	37,531	29,384	7,983	61,119	93,089	86,276	1,260	316,642

Integral to the assessment of the allowance process is an evaluation that is performed to determine whether a specific reserve on an impaired credit is warranted. At such time an action plan is agreed upon for the particular loan and an appraisal will be ordered (for real estate based collateral) depending on the time elapsed since the prior appraisal, the loan balance and/or the result of the internal evaluation. The Company's policy is to strictly adhere to regulatory appraisal standards. If an appraisal is ordered, no more than a 45 day turnaround is requested from the appraiser, who is selected from an approved appraiser list. After receipt of the updated appraisal, the Company's Watch Committee will determine whether a specific reserve or a charge-off should be taken based upon an impairment analysis. When potential losses are identified, a specific provision and/or charge-off may be taken, based on the then current likelihood of repayment, that is at least in the amount of the collateral deficiency, and any potential collection costs, as determined by the independent third party appraisal. Any further collateral deterioration may result in either further specific reserves being established or additional charge-offs. The President and the Chief Lending Officer have the authority to approve a specific reserve or charge-off between Watch Committee meetings to ensure that there are no significant time lapses during this process.

The Company's systematic methodology for evaluating whether a loan is impaired begins with risk-rating credits on an individual basis and includes consideration of the borrower's overall financial condition, resources and payment record, the sufficiency of collateral and, in a select few cases, support from financial guarantors. In measuring impairment, the Company looks to the discounted cash flows of the project itself or the value of the collateral as the primary sources of repayment of the loan. The Company will consider the existence of guarantees and the financial strength and wherewithal of the guarantors involved in any loan relationship as both a secondary source of repayment and for the potential as the primary repayment of the loan.

The Company typically relies on recent third party appraisals of the collateral to assist in measuring impairment.

Management has established a credit process that dictates that structured procedures be performed to monitor these loans between the receipt of an original appraisal and the updated appraisal. These procedures include the following:

- An internal evaluation is updated quarterly to include borrower financial statements and/or cash flow projections.
- The borrower may be contacted for a meeting to discuss an update or revised action plan which may include a request for additional collateral.
- Re-verification of the documentation supporting the Company's position with respect to the collateral securing the loan.
- At the Watch Committee meeting the loan may be downgraded and a specific reserve may be decided upon in advance of the receipt of the appraisal if it is determined that the likelihood of repayment is in doubt.

The Company generally follows a policy of not extending maturities on non-performing loans under existing terms. The Company may extend the maturity of a performing or current loan that may have some inherent weakness associated with the loan. Maturity date extensions only occur under terms that clearly place the Company in a position to assure full collection of the loan under the contractual terms and /or terms at the time of the extension that may eliminate or mitigate the inherent weakness in the loan. These terms may incorporate, but are not limited to additional assignment of collateral, significant balance curtailments/liquidations and assignments of additional project cash flows. Guarantees may be a consideration in the extension of loan maturities, but the Company does not extend loans based solely on guarantees. As a general matter, the Company does not view extension of a loan to be a satisfactory approach to resolving non-performing credits. On an exception basis, certain performing loans that have displayed some inherent weakness in the underlying collateral values, an inability to comply with certain loan covenants which are not affecting the performance of the credit or other identified weakness may be extended.

Collateral values or estimates of discounted cash flows (inclusive of any potential cash flow from guarantees) are evaluated to estimate the probability and severity of potential losses. A specific amount of impairment is established based on the Company's calculation of the probable loss inherent in the individual loan. The actual occurrence and severity of losses involving impaired credits can differ substantially from estimates.

Credit risk profile by portfolio segment based upon internally assigned risk assignments are presented below:

	December 31, 2013							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total

Credit quality indicators:								
Not classified	$50,884	$ 38,918	$ 8,266	$ 90,333	$ 113,301	$ 97,817	$ 1,174	$400,693
Special mention	-	-	-	-	-	-	-	-
Substandard	-	331	-	-	258	2,593	-	3,182
Doubtful	-	-	-	-	-	-	-	-
Total	$50,884	$ 39,249	$ 8,266	$ 90,333	$ 113,559	$ 100,410	$ 1,174	$403,875

	December 31, 2012							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Credit quality indicators:								
Not classified	$37,531	$ 29,384	$ 7,983	$ 61,119	$ 95,839	$ 86,701	$ 1,260	$319,817
Special mention	-	-	-	-	-	-	-	-
Substandard	432	442	-	-	384	1,143	-	2,401
Doubtful	-	-	-	-	-	-	-	-
Total	$37,963	$ 29,826	$ 7,983	$ 61,119	$ 96,223	$ 87,844	$ 1,260	$322,218

- **Special Mention** - A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
- **Substandard** - Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

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- **Doubtful** - Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loans classified Special Mention, Substandard, Doubtful or Loss are reviewed at least quarterly to determine their appropriate classification. All commercial loan relationships are reviewed annually. Non-classified residential mortgage loans and consumer loans are not evaluated unless a specific event occurs to raise the awareness of a possible credit deterioration.

An aged analysis of past due loans are as follows:

	December 31, 2013							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Analysis of past due loans:								
Accruing loans current	$50,884	$ 38,025	$ 8,266	$ 90,333	$ 113,142	$ 97,127	$ 1,174	$398,951
Accruing loans past due:								
31-59 days past due	-	570	-	-	-	150	-	720
60-89 days past due	-	323	-	-	-	244	-	567
Greater than 90 days past due	-	-	-	-	159	296	-	455
Total past due	$-	$ 893	$ -	$ -	$ 159	$ 690	$ -	$1,742
Non-accrual loans	-	331	-	-	258	2,593	-	3,182
Total loans	$50,884	$ 39,249	$ 8,266	$ 90,333	$ 113,559	$ 100,410	$ 1,174	$403,875

	December 31, 2012							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Analysis of past due loans:								
Accruing loans current	$37,531	$ 29,176	$ 7,942	$ 61,119	$ 95,839	$ 86,393	$ 1,260	$319,260
Accruing loans past due:								
31-59 days past due	-	-	-	-	-	-	-	-

60-89 days past due	-	-	-	-	-	308	-	308
Greater than 90 days past due	-	208	41	-	-	-	-	249
Total past due	$ -	$ 208	$ 41	$ -	$ -	$ 308	$ -	$ 557
Non-accrual loans	432	442	-	-	384	1,143	-	2,401
Total loans	$ 37,963	$ 29,826	$ 7,983	$ 61,119	$ 96,223	$ 87,844	$ 1,260	$ 322,218

Total loans either in non-accrual status or in excess of 90 days delinquent totaled $3.6 million, which is less than one percent of total loans outstanding, as of December 31, 2013 and represents an increase from the total of $2.6 million also less than one percent of total loans at December 31, 2012.

The impaired loans for the years ended December 31, 2013 and 2012 are as follows:

	December 31, 2013							
(in thousands)	Construction & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Impaired loans:								
Recorded investment	-	331	-	-	2,984	2,975	-	6,290
With an allowance recorded	-	331	-	-	258	677	-	1,266
With no related allowance recorded	-	-	-	-	2,726	2,298	-	5,024
Related allowance	-	4	-	-	31	224	-	259
Unpaid principal	-	331	-	-	2,984	2,978	-	6,293
Average balance of impaired loans	-	333	-	-	2,994	3,706	-	7,033
Interest income recognized	-	15	-	-	208	120	-	343

(in thousands)	December 31, 2012 Construction & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	Total
Impaired loans:								
Recorded investment	432	442	-	-	3,134	1,568	-	5,576
With an allowance recorded	432	442	-	-	381	540	-	1,795
With no related allowance recorded	-	-	-	-	2,753	1,028	-	3,781
Related allowance	21	138	-	-	148	257	-	564
Unpaid principal	432	442	-	-	3,372	1,580	-	5,826
Average balance of impaired loans	439	444	-	-	4,225	1,809	7	6,924
Interest income recognized	18	15	-	-	211	96	1	341

Included in the total impaired loans above were non-accrual loans of $3.2 million and $2.4 million at December 31, 2013 and 2012, respectively. Interest income that would have been recorded if non-accrual loans had been current and in accordance with their original terms, was $154 thousand, $113 thousand and $105 thousand for the years ended December 31, 2013, 2012 and 2011, respectively.

The Company did not transfer any loans to other real estate owned ("OREO") in 2013, and in 2012 transferred one loan totaling $1.6 million, net of reserves. Management routinely evaluates OREO based upon periodic appraisals. In 2013, 2012 and 2011, the Company recorded a valuation allowance of $347 thousand, $48 thousand and $777 thousand, respectively, in non-interest expense for properties whose current appraised value was less than the carried amount.

Loans may have their terms restructured (e.g., interest rates, loan maturity date, payment and amortization period, etc.) in circumstances that provide payment relief to a borrower experiencing financial difficulty. Such restructured loans are considered impaired loans that may either be in accruing status or non-accruing status. Non-accruing restructured loans may return to accruing status provided there is a sufficient period of payment performance in accordance with the restructure terms. Loans may be removed from the restructured category in the year subsequent to the restructuring if they have performed based on all of the restructured loan terms.

The trouble debt restructured loans ("TDRs") at December 31, 2013 and December 31, 2012 are as follows:

December 31, 2013

(dollars in thousands)	Number of Loans	Non-Accrual Status	Number of Loans	Accrual Status	Total TDRs
Commercial real estate non-owner occupied	-	$ -	-	$ -	$ -
Commercial loans	6	861	-	-	861
	6	$ 861	-	$ -	$ 861

	December 31, 2012				
(dollars in thousands)	Number of Loans	Non-Accrual Status	Number of Loans	Accrual Status	Total TDRs
Commercial real estate non-owner occupied	1	$ 381	-	$ -	$ 381
Commercial loans	6	903	-		