

MERCANTILE BANKSHARES CORP

Form 10-K

March 15, 2005

**United States**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(MARK ONE)

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**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES**

**EXCHANGE ACT OF 1934**

For the fiscal year ended **December 31, 2004**  
OR

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**TRANSITION REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES**

**EXCHANGE ACT OF 1934**

For the transition period from **to**  
Commission file number **0-5127**

**Mercantile Bankshares Corporation**

(Exact name of registrant as specified in its charter)

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

**52-0898572**  
(I.R.S. Employer  
Identification No.)

**Two Hopkins Plaza, P. O. Box 1477, Baltimore, Maryland 21203**  
(Address of principal executive offices)

Registrant's telephone number, including area code: **(410) 237-5900**

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

Title of each class	Name of each exchange on which registered
None	None

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

**Common Stock (\$2 par value)**

(Title of class)

**Stock Purchase Rights**

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(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark 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 an accelerated filer (as defined in Exchange Act Rule 12b-2)

Yes  No

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At June 30, 2004, the last business day of registrant's most recently completed second fiscal quarter, the aggregate market value of shares of common stock held by non-affiliates of registrant (1) (including fiduciary accounts administered by affiliates) was \$3,560,710,629 based on the last sale price on the Nasdaq National Market on June 30, 2004.

As of March 1, 2005, 79,237,620 shares of common stock were outstanding.

(1) Excludes 3,037,926 shares of Common Stock held by directors, executive officers, and shares held in fiduciary accounts by the Registrant and subsidiaries of the Registrant with discretionary power to vote or dispose of such shares as of June 30, 2004. Exclusion of shares held by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the Registrant, or that such person is controlled by or under common control with the Registrant.

Documents Incorporated by Reference: Part III - Definitive Proxy Statement of Registrant to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of the Registrant's fiscal year covered by this Annual Report on Form 10-K.

2004 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

**General**

Mercantile Bankshares Corporation was incorporated under the laws of Maryland on May 27, 1969. It is a financial holding company and a bank holding company registered under the Bank Holding Company Act of 1956. Mercantile Bankshares Corporation along with its consolidated subsidiaries is referred to in this report as Bankshares, we or Registrant. Bankshares, with \$14.4 billion in assets for the year ended December 31, 2004, is a regional multibank holding company with headquarters in Baltimore, Maryland. It is comprised of 13 banks (the Banks ) and a mortgage banking company. Ten banks are headquartered in Maryland, two are in Virginia and one is in Delaware. At December 31, 2004, Bankshares' largest bank, Mercantile-Safe Deposit and Trust Company ( MSD&T ), represented approximately 33% of total assets and operated 26 offices in Maryland and one commercial office in Pennsylvania. Nearly all Bankshares' substantial wealth management operations and specialized corporate banking services are provided by MSD&T.

**Washington Expansion and Affiliate Consolidation**

To capitalize on the potential in affluent, fast growing metropolitan Washington, D.C., Bankshares consolidated most of its retail and small business, commercial lending and real estate operations in the Washington region into its affiliate bank headquartered in Montgomery County, Maryland, and renamed the bank Mercantile Potomac Bank ( Mercantile Potomac ).

To further capitalize on the opportunities we see in the Washington region, Bankshares announced on January 25, 2005 that it had entered into a merger agreement to acquire Community Bank of Northern Virginia ( CBNV ) for total consideration of approximately \$212 million, 60% of which will be paid in the form of Bankshares common stock and 40% of which will be paid in cash. Under the terms of the merger agreement, shareholders of CBNV may elect to receive for each share of CBNV common stock they hold (excluding options), either .4005 shares of Bankshares common stock or cash in the amount of \$20.375, subject to adjustment because the ratio of stock to cash consideration is fixed. The merger is subject to CBNV shareholder approval and certain bank regulatory approvals, among other conditions. Bankshares filed a report on Form 8-K on January 25, 2005 disclosing the terms of this merger agreement. Please see this report for more details.

Bankshares also announced on January 25, 2005 that it would merge Mercantile Potomac into MSD&T in order to provide a more substantial capital base for funding the region's growth opportunities. Bankshares intends to operate the current branches of Mercantile Potomac as a division of MSD&T under the Mercantile Potomac Bank trade name. CBNV will become part of the Mercantile Potomac division upon completion of the acquisition. At the same time Bankshares announced that it would combine MSD&T and Mercantile Potomac, it also announced that it would merge its Western Maryland affiliate, The Fidelity Bank ( Fidelity ), into its Frederick-based affiliate, Farmers & Mechanics Bank ( Farmers ). Bankshares intends

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to operate the current branches of Fidelity as a division of Farmers under the Fidelity Bank trade name. The mergers of Mercantile Potomac into MSD&T and Fidelity into Farmers are both subject to regulatory approvals.

In 2004, Bankshares combined 11 of its banks into four banks in a strategic consolidation that positions its banking network to enhance customer service, to operate more efficiently and to respond more effectively to regulatory and competitive challenges. The consolidation affected banks located primarily in Delaware, southern Maryland and on the eastern shores of Maryland and Virginia. Each group of combined banks shared common geographic boundaries and common market dynamics. As with the Washington market consolidation, the four resulting banks were renamed in a manner that recognized their local identities while highlighting their Mercantile affiliation.

Bankshares places particular emphasis on long-term customer relationships by providing value-added services through its extensive affiliate bank network. Each of the Banks has its own identity, management team and board of directors. Perhaps most importantly, each Bank has strong historical ties to the families and businesses in the community it serves. Through its association with Bankshares, each Bank is able to provide its customers with the sophisticated banking services and financial resources of a major banking organization.

Bankshares directly owns all of the outstanding stock of the Banks and directly or indirectly owns all of the outstanding stock of certain other affiliates. The principal components of our banking and nonbanking network are listed below.

### *Lead Bank and Affiliates*

Mercantile-Safe Deposit and Trust Company

Mercantile Mortgage Corporation ( MMC )

Mercantile Mortgage, LLC (49.9% owned by MMC)

Columbia National Real Estate Finance LLC (60% owned by MMC)

West River LLC

HarborPoint Capital, GP LLC

HarborPoint Capital LP (75% owned by MMC)

Mercantile Brokerage Services Holdings, LLC

Mercantile Brokerage Services, Inc.

Mercantile Capital Advisors, Inc.

Mercantile/Cleveland, LLC

Boyd Watterson Asset Management, LLC

MBC Agency, Inc.

Mercantile Life Insurance Company



*Community Banks*

The Annapolis Banking and Trust Company	Annapolis, Maryland
The Citizens National Bank	Laurel, Maryland
Farmers & Mechanics Bank	Frederick, Maryland
Keller Stonebraker Insurance, Inc.	Hagerstown, Maryland
Potomac Basin Group Associates, Inc.	Beltsville, Maryland
The Fidelity Bank	Hagerstown, Maryland
Marshall National Bank and Trust Company	Marshall, Virginia
Mercantile County Bank	Elkton, Maryland
Mercantile Eastern Shore Bank	Chestertown, Maryland
Mercantile Peninsula Bank	Selbyville, Delaware
Mercantile Potomac Bank	Gaithersburg, Maryland
Mercantile Southern Maryland Bank	Leonardtown, Maryland
The National Bank of Fredericksburg	Fredericksburg, Virginia
Westminster Union Bank	Westminster, Maryland

For purposes of segment reporting, two operating components have been identified: Banking and Investment & Wealth Management. For segment reporting information, see Note No. 16 to the financial statements in Item 8 of this Annual Report and information under the heading Segment Reporting in the sections captioned Analysis of Operating Results for 2004 to 2003 and Review of Earnings and Balance Sheet for 2003 to 2002, in Item 7 of this Annual Report.

Bankshares periodically reviews and considers possible acquisitions of banks and other entities performing related activities and discusses such possible acquisitions with management of the subject companies, and such acquisitions, which may be material, may be made from time to time. Acquisitions are normally subject to regulatory approval.

**Consumer Banking Services***Personal Banking*

The Banks offer numerous services to meet the checking, savings, investment and credit needs of the individuals in their communities. Personal banking services include Individual Retirement Accounts, certificates of deposit and various checking and savings plans, including an

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indexed money market account. Investment services include mutual funds and annuities. The Banks offer home equity loans and lines of credit, as well as installment loans, to meet a variety of borrowing needs.

During 2004, Bankshares worked to create a consistent customer experience throughout the affiliate bank network by standardizing a number of banking office procedures and by simplifying and standardizing

its personal checking and savings accounts. Customer accounts will be converted to the new product line during 2005.

Through the affiliate bank network, customers have no-fee access to their accounts at 237 Banking Twenty-Four<sup>SM</sup> ATMs, and they can perform many routine transactions at any of the 226 affiliate banking offices. For added convenience, substantially all Bankshares affiliates provide customers with toll-free telephone access to a centralized Customer Service Center and a voice-response account information system. Banking Twenty-Four Online<sup>®</sup> enables customers to access their personal accounts online to pay bills, verify account balances, track recent account activity and perform selected transactions. Banking Twenty-Four Online offers sole proprietors similar and specifically tailored capabilities to meet small business needs.

### ***Home Mortgages***

Residential mortgages are provided through Mercantile Mortgage, LLC, a joint venture between Mercantile Mortgage Corporation ( Mercantile Mortgage ), a sub-sidiary of MSD&T, and Wells Fargo Ventures, LLC. A wide variety of competitively priced fixed- and variable-rate products are available, including jumbo loans. Residential mortgage loans also are available through the Banks.

Risks associated with residential mortgage lending include interest rate risk, which is mitigated through the sale of the majority of all conforming fixed-rate loans, and default risk by the borrower, which is mitigated through underwriting procedures and credit quality standards, among other things.

### **Commercial Banking Services**

#### ***Lending***

##### ***General Commercial Lending***

With their local knowledge and focus, our Banks are well-suited to meet the traditional credit needs of businesses in their market areas. Each Bank works closely with customers to extend credit for general business pur-poses, such as working capital, plant expansion or equipment purchases, and for financing industrial and commercial real estate. Where appropriate, the Banks are adept at employing government guarantee programs, such as those available from the Small Business Administration.

In addition to supplying credit to the businesses in its own market area, MSD&T works in collaboration with other affiliates when their customers' credit needs exceed the affiliate bank's lending limit or when there is a more specialized commercial banking need.

##### ***Specialized Lending***

When local commercial customers do not qualify for traditional financing, the Asset-Based Lending Group at MSD&T can help them convert the value of their accounts receivable, inventory and equipment into cash for operations. MSD&T lenders also work with the affiliate banks to arrange more sophisticated financing in the areas of acquisitions and management buyouts.

### *Real Estate Lending*

We provide land acquisition and development, construction and interim financing to commercial real estate investors and developers. Credits exceeding an affiliate bank's predetermined threshold are made in collaboration with the Real Estate Lending Group at MSD&T.

Mercantile Mortgage makes loans for land acquisition, development and construction of single-family and multifamily housing.

Permanent financing for multifamily projects and long-term, nonrecourse financing for commercial real estate are provided through Columbia National Real Estate Finance LLC ( CNREF ), a joint venture, the majority of which is owned by Mercantile Mortgage. CNREF is a Freddie Mac Program Plus Seller Servicer and is a MAP (Multifamily Accelerated Processing) approved lender for HUD. It has correspondent relationships with approximately 12 life insurance companies and services a loan portfolio in excess of \$5.8 billion.

Mercantile Mortgage also provides permanent financing for multifamily projects nationwide through HarborPoint Capital, LP, a joint venture, the majority of which is owned by Mercantile Mortgage. HarborPoint Capital, LP, headquartered in Dallas, Texas, is one of the nation's few Fannie Mae DUS (Delegated Underwriting and Servicing) lenders.

### *Cash Management*

Centralized at MSD&T, Cash Management Services helps business customers of all Banks collect, transfer and invest their cash. Through a variety of electronic payment and account management tools, Cash Management enables customers to monitor and manage cash flows conveniently and efficiently. In addition to use by commercial customers, Cash Management services are used by nonprofit institutions such as unions, charities and philanthropic organizations.

### *Capital Markets*

In November 2003, Bankshares developed the Capital Markets Group through MSD&T to provide additional financing capabilities for existing client relationships and to address the financing needs of an expanded universe of prospects. The Capital Markets Group underwrites and remarkets tax-exempt and taxable municipal variable-rate demand bonds for nonprofit organizations such as senior living and health care providers, private schools, health and social welfare organizations and cultural institutions. The Capital Markets Group also provides interest risk management and financial advisory services to all types of commercial banking customers. The Capital Markets Group specialists work directly with borrowers, evaluating and recommending financing and interest rate risk management strategies, including interest rate swaps, caps and collars.

The Capital Markets Group works closely with Bankshares' commercial lenders in Maryland, Virginia, Delaware, Pennsylvania and Washington, D.C., employing an approach that is consistent with Bankshares' community banking philosophy.



## **Investment and Wealth Management Services**

Bankshares offers investment and wealth management services through the Investment & Wealth Management division ( IWM ) of MSD&T. IWM continues to build on a 140-year tradition of providing premier investment and wealth management services to private individuals, family groups and institutions.

Today, Bankshares provides a range of wealth management services. Over the past several years, IWM has developed sophisticated risk management and asset allocation analyses to complement the investment advice we offer. An open architecture platform enables Bankshares to offer an array of proprietary investment products and carefully selected outside managers in a range of asset classes, including equity, fixed-income and alternative investment products. Bankshares' investment platform provides a range of investment vehicles, from separate account management to highly rated mutual funds. Investment and wealth management services are available through professional advisors at MSD&T, through the affiliate bank network and through Baltimore-based Mercantile Brokerage Services, Inc. ( MBSI ), which offers full-service, discount and online brokerage capabilities and account services. Sophisticated asset allocation and risk management capabilities, coupled with a range of proprietary and nonproprietary investment alternatives and investment vehicles, enable Bankshares to provide high quality, advice-driven, risk-managed solutions to meet clients' investment objectives. At December 31, 2004, Bankshares had \$22 billion of discretionary assets under management and \$47.8 billion in assets under administration.

### ***Private Wealth Management***

When managing a client's assets as part of an investment management or trustee relationship, Bankshares focuses on consistent investment performance and an asset allocation that is individually designed to meet each client's risk/return parameters and investment objectives. Professional advisors, working in partnership with our clients, provide access to proprietary and third-party separate account management, the family of Mercantile Funds, nonproprietary mutual funds and a variety of alternative investments. Through MBSI, our clients have access to full-service, discount and online brokerage capabilities. In addition, IWM provides a wide range of sophisticated fiduciary and client administrative services, including trust administration, protection and continuity of trust structures, estate settlement, estate advice and planning, tax advice and planning and charitable giving programs. IWM also acts in a custodial capacity for its clients, providing safekeeping of assets, transaction execution, income collection, preparation of tax returns and record keeping.

### ***Family Office***

Designed to service the unique needs of families with substantial wealth, the Family Office team works with 100 families whose total assets approach \$3.5 billion. The Family Office is comprised of leading professionals including Certified Financial Analysts, Certified Financial Planners and lawyers. The group integrates the full range of services required to seamlessly manage its clients' complex, multigenerational

financial circumstances. The Family Office offers family governance, family education and philanthropic advisory programs in addition to the normal services associated with Family Offices, such as investment management, trust structuring and administration, tax planning, estate planning, closely held business planning, credit, and charitable giving and administration. The team of specialists within Family Office also provides expert guidance in sophisticated investment strategies, incorporating nontraditional asset classes such as private equity, real estate and hedge fund investing.

### ***Private Banking***

The Private Banking Group provides one point of contact for its clients' deposit, investment and credit needs, ensuring that these services are delivered within an overall asset management plan. Private bankers can coordinate cash flows, arrange investment of short- and long-term funds and structure credit arrangements to meet short- to long-term needs.

### ***Institutional Asset Management***

Bankshares, through IWM, the Banks and Boyd Watterson Asset Management, LLC, works to provide businesses and charitable organizations with sophisticated investment management and administrative services for their employee retirement plans, profit sharing plans and endowments. Clients include state and local government entities, unions, charitable organizations and military institutions. For example, IWM is trustee for a group trust that focuses on commercial real estate investments for Taft-Hartley pension plans. IWM also can help nonprofit organizations, such as charitable and philanthropic groups, with annual giving and capital campaigns, pooled income funds, gift annuities and charitable remainder trusts. Bankshares offers corporations 401(k) programs tailored to their specific needs.

### **Insurance Activities**

Keller Stonebraker Insurance, Inc., an independent, wholly owned subsidiary of Farmers & Mechanics Bank, arranges a full line of consumer and commercial business insurance products through offices in Hagerstown and Cumberland, Maryland, and Keyser, West Virginia. Consumer insurance products include annuities, homeowners, automobile, life and personal umbrellas. Commercial products include property and casualty packages, workers' compensation, bonds, professional liability, umbrella, and 401(k) and other benefit plans.

Potomac Basin Group Associates, Inc., operates as an independent, wholly owned subsidiary of Farmers & Mechanics Bank and is an independent insurance agency specializing in corporate employee benefit plans through its offices in Beltsville and Ellicott City, Maryland.

MBC Agency, Inc., provides as agent, under group policies, credit life insurance in connection with extensions of credit by the Banks. Mercantile Life Insurance Company reinsures the insurance provided by MBC Agency, Inc.



**Private Equity**

Bankshares, in partnership with MSD&T, began a focused private equity investment initiative in 2000 with two objectives: providing an alternative method of funding to develop additional long-term client relationships with emerging companies in Bankshares' market area and providing an alternative use of capital to generate long-term returns. The primary investments are private equity limited partnerships located, or seeking investment opportunities, within Bankshares' geographic trade area and, to a lesser extent, direct investments in privately held companies within the region. The private equity funds include small- and middle-market buyout funds, mezzanine funds and late-stage venture funds where the target investments of the funds are or have the potential to become Bankshares customers. For more information on private equity investments, see Note Nos. 1, 6 and 10 of the financial statements.

**Other Nonbanking Affiliates**

On November 12, 2004, Mercantile consolidated its brokerage activities by merging Mercantile Securities, Inc., into Peremel & Company, Inc. The resulting entity is named Mercantile Brokerage Services, Inc., a general securities broker-dealer that offers full-service, discount and online brokerage services.

Mercantile Capital Advisors, Inc. is a registered investment adviser that provides investment advisory and administrative services to registered investment companies, including Mercantile Funds, Inc., a family of equity, taxable and tax-exempt bond, and money market funds.

**Statistical Information**

The statistical information required in this Item 1 is set forth in Item 6, 7 and 8 of this Annual Report on Form 10-K, as follows:

Disclosure Required by Guide 3	Reference to Caption in Item 6 or 7, or Note in Item 8
(I) Distribution of Assets, Liabilities and Stockholder Equity; Interest Rates and Interest Differentials	Analysis of Interest Rates and Interest Differentials (Item 7) Rate/Volume Analysis (Item 7) Nonperforming Assets (Item 7)
(II) Investment Portfolio	Bond Investment Portfolio (Item 7) Notes to Financial Statement, Note 3 Investment Securities
(III) Loan Portfolio	Year-End Loan Data (Item 6) Loan Maturity Schedule (Item 7) Interest Rate Risk (Item 7) Nonperforming Assets (Item 7)



(IV)	Summary of Loan Loss Experience	Allowance for Loan Losses (Item 7) Credit Risk Analysis (Item 7) Allocation of Allowance for Loan Losses (Item 7)
(V)	Deposits	Analysis of Interest Rates and Interest Differentials (Item 7) Notes to Financial Statements, Note 7 - Deposits
(VI)	Return on Equity and Assets	Return on Equity and Assets (Item 6)
(VII)	Short-Term Borrowings	Notes to Financial Statements, Note 8

### Employees

At December 31, 2004, Bankshares and its affiliates had approximately 3,479 employees.

### Competition

The banking business is highly competitive. Within their service areas, the Banks compete with commercial banks (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, and with insurance companies and other financial institutions for various types of loans. There is also competition for commercial and retail banking business from banks and financial institutions located outside our service areas. Interstate banking is an established part of the competitive environment. Bankshares is a financial holding company and is the largest independent bank holding company headquartered in Maryland. Measured in terms of assets under management and administration, MSD&T believes it is one of the larger trust institutions in the mid-atlantic region of the United States. MSD&T and its subsidiaries (i.e., Boyd Watterson & Mercantile Capital Advisors, Inc.) compete for various classes of fiduciary and investment advisory business with other banks and trust companies, insurance companies, investment counseling firms, mutual funds and others. Mercantile Mortgage is one of many competitors in its area of activity. MBC Agency, Inc. is limited to providing life, health and accident insurance in connection with credit extended by the Banks. Mercantile Agency, Inc. commenced business in 1996 and is a small competitor in its area.

The Banks ranged in asset size from approximately \$150 million to \$ 4.7 billion, at December 31, 2004. They face competition in their own local service areas as well as from the larger competitors mentioned above.

## Supervision and Regulation

### *Bankshares*

Bankshares, as a registered bank holding company, is subject to regulation and examination by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) under the Bank Holding Company Act of 1956, as amended (the BHC Act) and is required to file with the Federal Reserve Board quarterly and annual reports and such additional information as the Federal Reserve Board may require pursuant to the BHC Act. Among other provisions, the BHC Act and regulations promulgated thereunder require prior approval of the Federal Reserve Board of the acquisition by Bankshares of more than 5% of any class of the voting shares of any bank.

*Capital Adequacy.* The Federal Reserve Board, the Office of the Comptroller of the Currency (the OCC), the federal regulator of national banks, and the Federal Deposit Insurance Corporation (the FDIC), federal regulator of state-chartered banks that are not members of the Federal Reserve System and insurer of the deposits of all U.S. commercial banks, have issued substantially similar risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, these regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels, whether because of its financial condition or actual or anticipated growth.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least six percent, a total risk-based capital ratio of at least ten percent and a leverage ratio of at least five percent and not be subject to a capital directive order. As of December 31, 2004, the most recent notification from the primary regulators for each of Bankshares' subsidiary banks categorized them as well-capitalized under the prompt corrective action regulations. Additional information regarding capital requirements for bank holding companies and tables reflecting Bankshares' regulatory capital position at December 31, 2004 can be found in Note No. 11 to the financial statements in Item 8 of this Annual Report.

*The Gramm-Leach-Bliley Act.* The Gramm-Leach-Bliley Act of 1999 (the GLB Act) was adopted on November 12, 1999 and amended several of the federal banking laws, including the BHC Act

and the Banking Act of 1933 (generally known as Glass-Steagall ), that affect Bankshares and its subsidiaries. Prior to the adoption of the GLB Act, the activities of bank holding companies and their subsidiaries were restricted to banking, the business of managing and controlling banks, and other activities that the Federal Reserve Board had determined were so closely related to banking or managing or controlling banks as to be a proper incident thereto. In particular, Glass-Steagall and the BHC Act imposed important restrictions on the ability of bank holding companies or their subsidiaries to engage in the securities or insurance business.

The GLB Act repealed the provisions of Glass-Steagall and restrictions in the BHC Act that limited affiliations among, and overlapping business activities between the banking business and, respectively, the securities and insurance industries. With the adoption of the GLB Act, a bank holding company that makes an effective election to become a financial holding company may, within a holding company system, (a) engage in banking, or managing or controlling banks; (b) perform certain servicing activities for subsidiaries; and (c) engage in any activity, or acquire and retain the shares of any company engaged in any activity that is either (i) financial in nature or incidental to such financial activity, as determined by the Federal Reserve Board in consultation with the Secretary of the Treasury or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally, as determined by the Federal Reserve Board. Activities that are financial in nature include activities specified in the GLB Act and those activities that the Federal Reserve Board had determined, by order or regulation in effect prior to enactment of the GLB Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Thus, a financial holding company may engage in a full range of banking, securities and insurance activities, including securities and insurance underwriting, as well as, with certain restrictions, merchant banking activities. The election to become a financial holding company is only available to bank holding companies whose bank and thrift subsidiaries are well capitalized, well managed, and have satisfactory Community Reinvestment Act ratings.

With exceptions for insurance underwriting, merchant banking and real estate investment and development, the GLB Act also permits comparable expansion of national bank activities by banks meeting similar criteria, together with certain additional firewalls and other requirements, through financial subsidiaries of national banks. Similarly, as a matter of Federal law, but still subject to State law, the GLB Act expands the potential financial activities of subsidiaries of State banks. Bankshares filed an election and, on December 20, 2002, became a financial holding company.

The GLB Act also imposed a general scheme of functional regulation with respect to the activities of bank holding companies and their bank and nonbank subsidiaries to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators, although the Federal Reserve Board retains its role as the umbrella supervisor for bank holding companies. Consequently, various securities activities of bank subsidiaries of Bankshares are now subject to regulation by the Securities and Exchange Commission and

the National Association of Securities Dealers, Inc. The functional regulation of the securities brokerage activities of banks is not yet fully implemented.

As a result of the functional regulation imposed by the GLB Act, the Banks have moved certain securities activities that have become subject to Securities and Exchange Commission regulation into separate securities subsidiaries or affiliates. For example, MSD&T has two subsidiaries that engage in securities activities: Mercantile Capital Advisors, Inc., a registered investment adviser that advises the Mercantile family of mutual funds and certain other institutional accounts; and Mercantile Brokerage Services, Inc. (formerly Mercantile Securities, Inc. or Hopkins Plaza Securities, Inc.), a registered broker-dealer that facilitates the purchase of shares of mutual funds by bank customers and may engage in certain other activities in the future.

The GLB Act also implements a number of requirements designed to protect the privacy of customer information. A financial institution must inform its customers at the outset of the customer relationship, and at least annually thereafter, of the institution's privacy policies and procedures with respect to the customer's nonpublic personal financial information. With certain exceptions, an institution may not provide any nonpublic personal information to unaffiliated third parties unless the customer has been informed that such information may be so provided and the customer has been given the opportunity to opt out. Furthermore, the GLB Act limits a financial institution's use of a customer's account information for marketing purposes and imposes criminal penalties for the use of fraudulent or deceptive means to obtain personal customer financial information. The GLB Act permits states to adopt more rigorous laws with respect to privacy of customer information.

*The Fair Credit Reporting Act and the Fair and Accurate Transactions Act of 2003.* The Fair Credit Reporting Act ( FCRA ), among other provisions, restricts any bank from sharing with its affiliates certain information relating to its individual customers' creditworthiness and certain other matters unless the information consists solely of transactions or experiences ( Transaction or Experience Information ) between the customer and the bank or the bank notifies the customer that Transaction or Experience Information may be shared and gives the customer the opportunity to opt out. FCRA preempts state laws that purport to restrict further such information sharing among affiliated institutions. The Fair and Accurate Transactions Act of 2003 (the FACT Act ), which was signed into law on December 4, 2003, makes permanent the preemption of state law restrictions on affiliate information sharing that is permitted by FCRA and amends FCRA in various respects, including to enhance the ability of consumers to combat identity theft, increase the accuracy of consumer credit reports, and allow consumers to exercise greater control over the type and amount of marketing solicitations that they receive. The new marketing restrictions, with some exceptions, would prevent banks from using Transaction or Experience Information received from an affiliate for marketing to a consumer unless the consumer was given notice and an opportunity to opt out. The FACT Act also restricts the sharing of certain types of consumer medical information among affiliates. These new restrictions on sharing or using information shared among affiliates must be implemented by regulations which were issued for public comment but have not yet been

finalized. More generally, the Federal Reserve Board and the Federal Trade Commission have issued joint final rules establishing December 1, 2004 as the effective date for many of the provisions of the FACT Act that will require significant changes to affected companies' business practices.

In December 2004, implementing section 216 of the FACT Act, the federal bank regulatory agencies announced interagency final rules to require financial institutions to adopt measures for properly disposing of consumer information derived from credit reports. Federal banking law requires financial institutions to protect customer information by implementing information security programs. The rules adopted by the banking agencies require institutions to make certain adjustments to their information security programs to include measures for the proper disposal of consumer information. The rules define consumer information to mean any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the [institution] for a business purpose, and include a compilation of such records, but exclude any record that does not identify an individual. The rules take effect on July 1, 2005.

*The USA PATRIOT ACT.* Congress adopted the USA PATRIOT ACT (the Patriot Act) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, banks are required to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Specifically, the customer identification program (CIP) regulation issued under the Patriot Act requires each bank to implement a written CIP appropriate for its size and type of business that includes certain minimum requirements. The CIP must be incorporated into the bank's anti-money laundering compliance program, which is subject to approval by the bank's board of directors. The regulation applies to all federally regulated banks and savings associations, credit unions, and non-federally regulated private banks, trust companies, and credit unions. All banks were required to comply with the CIP regulation for all accounts established on or after October 1, 2003.

*Interstate Banking* Pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Banking and Branching Act), a bank holding company may acquire banks located in states other than its home state without regard to the permissibility of such acquisitions under state law, but subject to any state requirement that the bank has been organized and operating for a minimum period of time, not to exceed five years, and the requirement that the bank holding company, after the proposed acquisition, controls no more than 10 percent of the total amount of deposits of insured depository institutions in the United States and no more than 30 percent or such lesser or greater amount set by state law of such deposits in that state.

Subject to certain restrictions, the Interstate Banking and Branching Act also authorizes banks to merge across state lines to create interstate banks. The Interstate Banking and Branching Act also permits a

bank to open new branches in a state in which it does not already have banking operations if such state enacts a law permitting de novo branching.

*Other Regulatory Matters* In addition to the specific laws and regulations discussed above, there are numerous federal and state laws and regulations which regulate the activities of Bankshares and the Banks, including requirements and limitations relating to reserves, permissible investments and lines of business, transactions with officers, directors and affiliates, loan limits, consumer protection laws, privacy of financial information, predatory lending, fair lending, mergers and acquisitions, issuances of securities, dividend payments, inter-affiliate liabilities, extensions of credit and branch banking. The BHC Act and the Federal Reserve Board's regulations limit the ability of bank subsidiaries of bank holding companies to engage in certain tie-in arrangements with bank holding companies and their nonbank subsidiaries in connection with any extension of credit or provision of any property or services, subject to various exceptions.

The laws and regulations to which Bankshares is subject are constantly under review by Congress, regulatory agencies and state legislatures. The likelihood and timing of any bank proposals or legislation and the impact they might have on Bankshares and its subsidiaries cannot be determined at this time.

Bankshares is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries and interest payments from the Banks on subordinated debt. These dividends are the principal source of funds to pay dividends on Bankshares' common stock and interest on its debt. The payment of dividends by a bank is subject to federal law restrictions as well as to the laws of its state of incorporation in the case of a state-chartered bank. Also, a parent company's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. It is Federal Reserve Board policy that a bank holding company should serve as a source of financial and managerial strength for, and commit resources to support each, of its subsidiary banks even in circumstances in which it might not do so (or may not legally be required or financially able to do so) absent such a policy.

Changes in control of Bankshares and the Banks are regulated under the BHC Act, the Change in Bank Control Act of 1978 and various state laws.

### ***The Banks***

In 2004, several of the Banks were merged, as follows:

The Forest Hill State Bank was merged into County Banking and Trust Company, which survived after the merger under the name Mercantile County Bank



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The First National Bank of St. Mary's at Leonardtown and Bank of Southern Maryland were both merged into Calvert Bank and Trust Company, which survived the merger under the name Mercantile Southern Maryland Bank

St. Michaels Bank and The Peoples Bank of Maryland were both merged into The Chestertown Bank of Maryland, which survived the merger under the name Mercantile Eastern Shore Bank

Peninsula Bank and Farmers & Merchants Bank-Eastern Shore were both merged into Baltimore Trust Company, which survived the merger under the name Mercantile Peninsula Bank

These mergers were intended to enhance the delivery of services in the geographic areas served by the Banks involved. In each case, merging several smaller Banks produced surviving institutions that, because of their larger size, are now able to allocate internal management responsibilities more effectively. In some cases, the surviving Banks also have higher legal lending limits, which allows them to be more responsive to customers' borrowing needs.

All the Banks, with the exception of The Citizens National Bank, The National Bank of Fredericksburg, Marshall National Bank and Trust Company and Mercantile Peninsula Bank are Maryland banks, subject to the banking laws of Maryland and to regulations issued by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). Their deposits are insured by, and they are subject to certain provisions of federal law and regulations and examination by, the FDIC.

In addition, The Annapolis Banking and Trust Company and Farmers & Mechanics Bank are members of the Federal Reserve System, and are thereby subject to regulation by the Federal Reserve Board.

The Citizens National Bank, The National Bank of Fredericksburg and Marshall National Bank and Trust Company are national banks subject to regulation and regular examination by the OCC in addition to regulation and examination by the FDIC, which insures their deposits.

Mercantile Peninsula Bank is a Delaware bank, subject to the banking laws of Delaware and to regulation by the Delaware State Bank Commissioner, who is required by statute to make periodic examinations. Its deposits are insured by, and it is subject to certain provisions of federal law and regulation and examination by the FDIC.

Bankshares and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W, which implements Sections 23A and 23B. Section 23A, among other provisions, limits the amount of loans or extensions of credit by the Banks to, and their investments in, Bankshares and the nonbank affiliates of the Banks, while Section 23B generally requires that transactions between the Banks and Bankshares and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates. Under the cross-guarantee provisions of the Federal Deposit Insurance Act, in the event of a loss suffered or anticipated by the FDIC - either as a result of default of a bank subsidiary or related to FDIC assistance provided to a bank subsidiary in danger of default - the Banks may be assessed for the FDIC's loss, subject to certain exceptions.

#### *Other Affiliates*

As affiliates of Bankshares, the nonbank affiliates are subject to examination by the Federal Reserve Board and, as affiliates of the Banks, they are subject to examination by the FDIC, the



Commissioner of Financial Regulation of Maryland and the OCC, as the case may be. In addition, MBC Agency, Inc., Mercantile Life Insurance Company and Mercantile Agency, Inc. are subject to licensing and regulation by state insurance authorities. Mercantile Capital Advisors, Inc., Boyd Watterson and Mercantile Brokerage Services, Inc. are subject to regulation by the Securities and Exchange Commission and state securities law authorities, and Mercantile Brokerage Services, Inc. are also subject to regulation by the National Association of Securities Dealers, Inc. Retail sales of insurance and securities products by Mercantile Agency, Inc. and Mercantile Brokerage Services, Inc. are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the Federal Reserve Board, the Comptroller of the Currency and the Office of Thrift Supervision.

### *Effects of Monetary Policy*

All commercial banking operations are affected by the Federal Reserve System's conduct of monetary policy and its policies change from time to time based on changing circumstances. The Federal Reserve Board effectively controls national supply of bank credit in order to achieve economic results deemed appropriate by its Federal Reserve Board, including efforts to combat unemployment, recession or inflationary pressures. Among the instruments of monetary policy used to implement these objectives are open market operations in the purchase and sale of U.S. Government securities, changes in the discount rate charged on bank borrowings and changes in reserve requirements against bank deposits. These means are used in varying combinations to influence the general level of interest rates and the general availability of credit. More specifically, actions by the Federal Reserve Board influence the levels of interest rates paid on deposits and other bank funding sources and charged on bank loans as well as the level of availability of bank funds with which loans and investments can be made.

### **Cautionary Statement**

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. A forward-looking statement encompasses any estimate, prediction, opinion or statement of belief contained in this report, and the underlying management assumptions. These forward-looking statements include such words as believes, expects, anticipates, intends and similar expressions. Examples of forward-looking statements in this Annual Report on Form 10-K are statements concerning competitive conditions, effects of monetary policy, the potential impact of legislation, identification of trends, loan growth, customer borrowing trends, anticipated level of interest rates, business strategies and services, continuation or development of specified lending and other activities, credit quality, predictions or assessments related to determination and adequacy of loan loss allowances, monitored loans, internal controls, tax accounting, importance and effects of capital levels, effects of asset sensitivity and interest rates, earnings simulation model projections, efforts to mitigate market and liquidity risks, dividend payments and impact of FASB pronouncements. These statements are based on current expectations and assessments of potential developments affecting market conditions, interest rates and other economic

conditions, and results may ultimately vary from the statements made in 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: (1) the interest rate environment may further compress margins and adversely affect net interest income; (2) results may be adversely affected by continued diversification of assets and adverse changes to credit quality; (3) economic slowdown could adversely affect credit quality and loan originations; (4) loan growth may not improve to a degree that would help offset continuing pressure on net interest margin; (5) adverse governmental or regulatory policies may be enacted; (6) the expected growth opportunities or cost savings from our merger with Community Bank of Northern Virginia may not be fully realized or may take longer to realize than expected; (7) Community Bank of Northern Virginia's actual earnings may not be as strong as projected; (8) declines in equity and bond markets may adversely affect IWM revenues; and (9) the inability to manage adequately the spread between yields on earning assets and cost of funds could adversely affect results.

#### **Website Access To Information**

Bankshares' annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports may be accessed through Bankshares' website as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission. Bankshares' website is [www.mercantile.com](http://www.mercantile.com).

#### ITEM 2.

#### PROPERTIES

The main offices of Bankshares and MSD&T are located in a 21-story building at Two Hopkins Plaza in Baltimore, Maryland, which is owned by MBC Realty, LLC, a wholly-owned subsidiary of Harbor Group International, L.L.C. Pursuant to a lease agreement by and between MBC Realty, LLC (which was previously owned by Bankshares) and MSD&T, effective as of December 13, 2004, MSD&T agreed to lease up to approximately 179,000 square feet of prime office space and approximately 27,000 square feet of back office and storage space at Two Hopkins Plaza, for a term of ten years. At December 31, 2004, MSD&T and Bankshares occupied approximately 206,000 square feet. The lease agreement contains two five-year renewal options. The lease agreement requires aggregate annual rent of approximately \$3,900,000 in 2005. At December 31, 2004, Bankshares also occupied approximately 132,000 square feet of leased space in a building located in Linthicum, Maryland, in which its operations and certain other departments are located, and a 7,000 square foot call center facility in Federalsburg, Maryland. The Linthicum and Federalsburg properties are owned by Bankshares. Of the 226 banking offices, 111 are owned in fee, 32 are owned subject to ground leases and 83 are leased, with aggregate annual rentals of approximately \$ 8,797,000 as of December 31, 2004.

ITEM 3. LEGAL PROCEEDINGS

On July 12, 2004 former employee John Pileggi filed suit against Bankshares, MSD&T and Edward J. Kelly. The complaint alleges that the public statements made by the defendants regarding the circumstances of Mr. Pileggi's termination gives rise to claims of libel, invasion of privacy and false light. Mr. Pileggi also alleges breach of contract. The complaint seeks actual and punitive damages amounting to \$240 million. MSD&T terminated Mr. Pileggi's employment on March 18, 2004 for the reasons set out in a press release of that same date. Bankshares believes the suit is without merit.

On September 27, 2004, Bankshares and MSD&T filed a countersuit against Mr. Pileggi. The countersuit alleges that Mr. Pileggi, during his employment with MSD&T, engaged in activities that constituted fraud, breach of contract, and breach of his fiduciary duty to MSD&T, including, but not limited to, the activity described in MSD&T's press release dated March 18, 2004. The countersuit seeks compensatory and punitive damages amounting to \$8,200,000, along with other appropriate relief.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the fourth quarter of the fiscal year covered by this Report to a vote of security holders which is required to be disclosed pursuant to the instructions contained in the form for this Report.

SPECIAL ITEM: EXECUTIVE OFFICERS OF THE REGISTRANT

The members of Bankshares' holding company management committee are:

Name	Position	Age
Edward J. Kelly, III	Chairman, President and Chief Executive Officer	51
Alexander T. Mason	Vice Chairman and Chief Operating Officer, Bankshares	53
J. Marshall Reid	President and Chief Operating Officer, MSD&T	59
Kenneth A. Bourne, Jr.	Executive Vice President, Banking Division, MSD&T	62
Peter W. Floeckher, Jr.	Executive Vice President, Affiliate Management, Bankshares	55
Jay M. Wilson	Vice Chairman, Bankshares; Chief Executive Officer, Investment and Wealth Management	58

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Kevin A. McCreddie	Chief Investment Officer, Investment and Wealth Management	44
Terry L. Troupe	Executive Vice President and Chief Financial Officer, Bankshares	57
John L. Unger	Executive Vice President and General Counsel, Bankshares	51
Michael M. Paese	Executive Vice President, Chief Administrative Officer, Chief Risk Officer and Deputy General Counsel, Bankshares	37
Deborah A. Kakaris	Executive Vice President, Operations and Technology Services, Bankshares	41
Frank K. Turner, Jr.	Executive Vice President, Corporate and Correspondent Banking Services, Bankshares	49
Priscilla S. Hoblitzell	Senior Vice President, Investment Banking/Strategic Planning, Bankshares	44
Kaye A. Simmons	Senior Vice President and Treasurer, Bankshares	49
Ellen D. Harvey	Senior Vice President, Fixed Income Portfolio Manager, Bankshares	51

No family relationships, as defined by the rules and regulations of the Securities and Exchange Commission, exist among any of the Executive Officers. All officers are elected annually by the Board of Directors and hold office at the pleasure of the Board.

Effective March 1, 2001, Mr. Kelly became President and Chief Executive of Bankshares and Chairman of the Board and Chief Executive Officer of MSD&T. In addition, effective March 1, 2003 Mr. Kelly became Chairman of Bankshares. Mr. Kelly served as Managing Director, Head of Global Financial Institutions, and as Co-Head of Investment Banking Client Management of J. P. Morgan, Chase & Co. during January, 2001. Prior thereto, he was a Managing Director of J. P. Morgan & Co. Incorporated and held the following additional positions with that Company: Head, Global Financial Institutions from February, 2000 through December, 2000; Co-Head, Global Financial Institutions and Head, Latin America Investment Banking from December, 1997 through February, 2000; Member, Global Investment Banking Committee from December, 1997 through December, 2000; and Co-Head, Financial Institutions (Americas) from February, 1996 through December, 1997.

Mr. Mason joined Bankshares in November, 2003, and is Vice Chairman of Bankshares. Effective January 2, 2005, he was named Bankshares Chief Operating Officer. Prior to joining Bankshares, he was Vice Chairman of Deutsche Bank in the Americas and Managing Director of Deutsche Bank Securities. He also served as chief operating officer of the firm's Global Corporate Finance Department and headed up the

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firms Global Industry Group practice. He was elected a director of MSD&T in January, 2005, and a director of Bankshares in January, 2005.

Mr. Reid was elected President and Chief Operating Officer of MSD&T in September, 1997. He joined MSD&T as a Senior Vice President in 1993 and served as an Executive Vice President from 1994 until September, 1997.

Mr. Bourne has been an Executive Vice President of MSD&T since 1989. He joined the bank as a trainee in 1970.

Mr. Floeckher was appointed Executive Vice President and Head of the Affiliates for Bankshares in November, 2003. He served as President and Chief Executive Officer of Citizens National Bank from 1995 until November, 2003. Mr. Floeckher is responsible for oversight of the Banks, which includes risk management, compliance and enhanced performance through coordinated sharing of best practices.

Mr. Wilson has been a Vice Chairman of Bankshares, and Chief Executive Officer of the Investment and Wealth Management Division of MSD&T since January 2005. From September 1998 until December 2004, he was General Partner of Spring Capital Partners, L.P., a private equity fund providing expansion and acquisition capital to emerging growth companies. He was elected a director of MSD&T in January 2005, and a director of Bankshares in January 2005.

Mr. McCreadie joined the Investment and Wealth Management Division of MSD&T in 2002, and is the Chief Investment Officer of that Division. Previously, he was a Partner at Brown Investment Advisory & Trust Company, from 1999-2002, where he was a Senior Portfolio Manager and Co-head of Portfolio Management, and a member of the firm's Investment and Operating Committees. Prior to that, Mr. McCreadie was a Vice President and Portfolio Manager for J.P. Morgan Investment Management, where he was employed from 1981-1999.

Mr. Troupe has been Chief Financial Officer of Bankshares and MSD&T since September, 1996.

Mr. Unger became General Counsel on March 23, 2002 and was elected Secretary of Bankshares and MSD&T on July 1, 2002. Prior to joining Bankshares, Mr. Unger was General Counsel to IMI Resort Holdings, Inc., a privately held real estate company in Greenville, South Carolina.

Mr. Paese was named Chief Administrative Officer of Bankshares in November, 2003, is Deputy General Counsel, and became Chief Risk Officer on January 2, 2005. He joined MSD&T as a Senior Vice President in January, 2003. Before joining Mercantile, Mr. Paese was Senior Counsel to the Financial Services Committee of the U.S. House of Representatives (minority). Mr. Paese advised the Committee on legal and policy issues relating to U.S. capital markets and corporate governance. Prior thereto, Mr. Paese was Vice President in equity capital markets, at J.P. Morgan & Co. Incorporated. Prior thereto, Mr. Paese was an associate at Davis, Polk & Wardwell.

Mrs. Kakaris has been an Executive Vice President of Bankshares and MSD&T since 2002. She is responsible for Operations and Technology Services. Mrs. Kakaris joined the bank in 1988 and served as a Senior Vice President from 1997 until March, 2002.





Mr. Turner is an Executive Vice President of Bankshares and MSD&T. Mr. Turner began his banking career with Mercantile in 1978. He is currently responsible for the syndicated lending, correspondent banking and private equity groups.

Ms. Hoblitzell joined Bankshares as a Senior Vice President in April, 2003. Prior to joining Bankshares, she was self-employed. Prior thereto, Ms. Hoblitzell was a Vice President at Goldman, Sachs & Co.

Ms. Simmons joined Bankshares in 2003, after the merger with F&M Bancorp. She had been Treasurer of F&M Bancorp since 2000 and Executive Vice President and Chief Financial Officer of Farmers & Mechanics Bank since 2000. Prior to that time, Ms. Simmons served as Senior Vice President of Finance and Treasurer of Citizens Bancorp from 1989 to 1997.

Ms. Harvey joined Bankshares in 2003 as a Senior Vice President and Fixed Income Portfolio Manager. From April, 2000 until December, 2002, she was a partner and manager of Fixed Income with Brown Advisory in Baltimore. Previously, she was a principal of Morgan Stanley from January, 1996 until December, 1999, where she served as Fixed Income Portfolio Manager.

## **PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES**

For information regarding market prices, dividends on Bankshares common stock, and the number of Bankshares stockholders, see the information set forth under the captions "Dividends" and "Recent Common Stock Prices" in Item 7 of this Annual Report.

**ISSUER PURCHASES OF EQUITY SECURITIES**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan or Programs</b>
October 1, 2004				
October 31, 2004	<b>0</b>		<b>0</b>	<b>476,327</b>
November 1, 2004				
November 30, 2004	<b>6,886(1)</b>	<b>\$ 50.93</b>	<b>0</b>	<b>476,327</b>
December 1, 2004				
December 31, 2004	<b>0</b>		<b>0</b>	<b>476,327</b>

(1) Represents outstanding shares surrendered in connection with exercise of options.

ITEM 6. SELECTED FINANCIAL DATA

## Five-Year Selected Financial Data

Years Ended December 31,  
(Dollars in thousands, except per  
share data)

	2004	2003	2002	2001	2000
NET INTEREST INCOME	\$ 545,781	\$ 472,349	\$ 441,035	\$ 417,327	\$ 408,434
NET INCOME	\$ 229,407	\$ 196,814	\$ 190,238	\$ 181,295	\$ 175,230
NET INCOME PER SHARE OF COMMON STOCK					
Basic	\$ 2.90	\$ 2.70	\$ 2.74	\$ 2.57	\$ 2.53
Diluted	\$ 2.87	\$ 2.68	\$ 2.72	\$ 2.55	\$ 2.51
TOTAL ASSETS	\$ 14,425,690	\$ 13,695,472	\$ 10,790,376	\$ 9,928,786	\$ 8,938,030
LONG-TERM DEBT	\$ 690,955	\$ 647,722	\$ 287,214	\$ 269,437	\$ 92,547
PROVISION FOR LOAN LOSSES	\$ 7,221	\$ 12,105	\$ 16,378	\$ 13,434	\$ 17,231
PER SHARE CASH DIVIDENDS					
Common	\$ 1.38	\$ 1.29	\$ 1.18	\$ 1.10	\$ 1.02
CASH DIVIDENDS DECLARED AND PAID					
On common stock	\$ 109,295	\$ 95,842	\$ 81,909	\$ 77,597	\$ 70,641
YEAR-END LOAN DATA					
Commercial	\$ 2,820,752	\$ 2,577,021	\$ 2,300,956	\$ 2,228,750	\$ 2,215,039
Commercial real estate	3,115,274	2,738,832	2,016,307	1,819,268	1,409,987
Construction	1,268,350	1,064,021	810,985	652,486	824,752
Residential real estate	1,486,106	1,335,375	1,066,694	1,060,519	1,086,674
Consumer	989,121	1,067,360	775,673	801,474	832,206
Home equity lines	495,462	415,500	239,232	189,867	168,944
Lease financing	53,368	74,051	102,180	153,882	155,692
Total loans	10,228,433	9,272,160	7,312,027	6,906,246	6,693,294
Less:					
Allowance for loan losses	(149,002)	(155,337)	(138,601)	(141,463)	(138,612)
Loans, net	\$ 10,079,431	\$ 9,116,823	\$ 7,173,426	\$ 6,764,783	\$ 6,554,682

## Five-Year Summary of Consolidated Income

Years Ended December 31, (Dollars in thousands)	2004	2003	2002	2001	2000
<b>INTEREST INCOME</b>					
Interest and fees on loans	\$ 546,531	\$ 472,943	\$ 468,678	\$ 543,242	\$ 548,360
Interest and dividends on securities	111,003	113,254	112,091	99,624	95,736
Other interest income	1,503	3,397	4,848	5,986	1,448
Total interest income	659,037	589,594	585,617	648,852	645,544
<b>INTEREST EXPENSE</b>					
Interest on deposits	83,403	93,190	122,569	199,703	182,448
Interest on short-term borrowings	7,844	5,604	11,259	25,120	48,711
Interest on long-term debt	22,009	18,451	10,754	6,702	5,951
Total interest expense	113,256	117,245	144,582	231,525	237,110
NET INTEREST INCOME	545,781	472,349	441,035	417,327	408,434
Provision for loan losses	7,221	12,105	16,378	13,434	17,231
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	538,560	460,244	424,657	403,893	391,203
<b>NONINTEREST INCOME</b>					
Investment and wealth management	90,050	78,933	68,435	69,331	69,850
Service charges on deposit accounts	44,263	39,194	33,539	30,101	26,194
Other income	79,616	65,445	42,545	46,972	30,448
Total noninterest income	213,929	183,572	144,519	146,404	126,492
<b>NONINTEREST EXPENSES</b>					
Salaries and employee benefits	232,297	198,043	165,371	152,887	140,391
Net occupancy and equipment expenses	55,746	52,366	40,368	38,448	34,607
Amortization of goodwill				9,072	5,213
Other expenses	103,915	87,038	66,869	63,552	63,294
Total noninterest expenses	391,958	337,447	272,608	263,959	243,505
Income before income taxes	360,531	306,369	296,568	286,338	274,190
Applicable income taxes	131,124	109,555	106,330	105,043	98,960
NET INCOME	\$ 229,407	\$ 196,814	\$ 190,238	\$ 181,295	\$ 175,230

## Five-Year Statistical Summary

Years Ended December 31, (Dollars in thousands)	2004	2003	2002	2001	2000
<b>AVERAGE BALANCE SHEET STATISTICS</b>					
Loans:					
Commercial	\$ 2,733,580	\$ 2,485,622	\$ 2,371,395	\$ 2,412,371	\$ 2,240,283
Commercial real estate	2,919,840	2,309,712	1,911,927	1,565,964	1,294,615
Construction	1,144,044	929,939	733,237	795,931	738,393
Residential real estate	1,444,148	1,171,194	1,072,297	1,059,798	950,531
Consumer	1,477,797	1,192,515	999,988	998,792	945,810
Total loans	9,719,409	8,088,982	7,088,844	6,832,856	6,169,632
Federal funds sold, et al	59,848	250,462	178,624	141,245	29,434
Securities:					
U.S. Government obligations	1,551,141	1,731,032	2,089,004	1,705,543	1,628,477
States and political subdivisions	94,308	69,888	38,799	40,359	25,170
Mortgage-backed securities	1,250,947	927,235	216,391	48,203	21,252
Other investments (1)	57,351	29,889	9,489	9,188	7,031
Total securities	2,953,747	2,758,044	2,353,683	1,803,293	1,681,930
Total earning assets	\$ 12,733,004	\$ 11,097,488	\$ 9,621,151	\$ 8,777,394	\$ 7,880,996
Deposits:					
Noninterest-bearing deposits	\$ 2,879,290	\$ 2,269,720	\$ 1,856,706	\$ 1,618,838	\$ 1,438,578
Savings deposits (2)	4,286,180	3,597,185	2,936,197	2,471,674	2,345,808
Time deposits	3,248,222	3,124,949	2,839,507	2,958,158	2,412,468
Total deposits	\$ 10,413,692	\$ 8,991,854	\$ 7,632,410	\$ 7,048,670	\$ 6,196,854
Borrowed funds:					
Short-term borrowings	\$ 932,493	\$ 851,348	\$ 845,938	\$ 744,907	\$ 860,241
Long-term debt	645,375	517,386	279,471	117,823	87,679
Total borrowed funds	\$ 1,577,868	\$ 1,368,734	\$ 1,125,409	\$ 862,730	\$ 947,920
<b>AVERAGE RATES (3)</b>					
Loans:					
Commercial	5.31%	5.44%	6.26%	7.88%	9.33%
Commercial real estate	5.95	6.16	6.85	8.16	8.84
Construction	5.46	5.41	6.09	7.96	9.66
Residential real estate	5.90	6.46	7.30	7.94	7.98
Consumer	5.72	6.25	7.12	8.28	8.70
Total loans	5.67	5.91	6.68	8.02	8.96
Federal funds sold, et al	2.51	1.33	2.71	4.23	4.89
Securities:					
U.S. Government obligations	3.69	4.25	4.67	5.48	5.67
States and political subdivisions	5.73	6.50	8.08	8.17	8.26
Mortgage-backed securities	3.85	3.90	5.59	7.47	7.48
Other investments (1)	4.17	2.90	6.78	8.21	10.07
Total securities	3.83	4.19	4.82	5.61	5.75
Composite rate earned	5.23%	5.37%	6.15%	7.47%	8.26%
Deposits:					
Savings deposits (2)	0.37%	0.46%	0.87%	1.62%	2.06%
Time deposits	2.08	2.45	3.42	5.40	5.56
Total interest-bearing deposits	1.11	1.39	2.12	3.68	3.83
Borrowed funds:					
Short-term borrowings	0.84	0.66	1.33	3.37	5.66
Long-term debt	3.41	3.57	3.85	5.69	6.79
Total borrowed funds	1.89	1.76	1.96	3.69	5.77
Composite rate paid	1.24%	1.45%	2.10%	3.68%	4.16%

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- (1) Includes interest-bearing deposits in other banks.
  - (2) Includes savings, checking plus interest and money market deposit accounts.
  - (3) Presented on a tax-equivalent basis.

Years Ended December 31, (Dollars in thousands)	2004	2003	2002	2001	2000
<b>RETURN ON EQUITY AND ASSETS</b>					
Average total assets	\$ 13,992,971	\$ 11,971,581	\$ 10,123,457	\$ 9,227,202	\$ 8,299,316
Average shareholders equity	\$ 1,871,670	\$ 1,497,145	\$ 1,257,967	\$ 1,197,058	\$ 1,054,071
Return on average total assets	1.64%	1.64%	1.88%	1.96%	2.11%
Return on average shareholders equity	12.26%	13.15%	15.12%	15.15%	16.62%
Average shareholders equity as a percent of average total assets	13.38%	12.51%	12.43%	12.97%	12.70%
Dividends paid per share as a percent of basic net income per share	47.6%	47.8%	43.1%	42.8%	40.3%
<b>SOURCES OF INCOME</b>					
Commercial loans	16.3%	17.1%	19.9%	23.4%	26.5%
Commercial real estate loans	19.8	18.2	17.9	16.0	14.8
Construction loans	7.1	6.3	5.9	7.9	9.2
Residential real estate loans	9.7	9.8	10.7	10.6	9.8
Consumer loans	9.7	9.6	9.8	10.4	10.7
Federal funds sold, et al	0.2	0.4	0.6	0.8	0.2
Securities	12.7	14.9	15.4	12.5	12.4
Total interest income	75.5	76.3	80.2	81.6	83.6
Investment and wealth management	10.3	10.2	9.4	8.7	9.1
Other income	14.2	13.5	10.4	9.7	7.3
Total income	100.0%	100.0%	100.0%	100.0%	100.0%
<b>NET INTEREST INCOME (Tax Equivalent)</b>					
Interest earned:					
Loans	\$ 551,062	\$ 477,840	\$ 473,500	\$ 548,192	\$ 552,966
Federal funds sold, et al	1,501	3,337	4,833	5,968	1,439
Taxable securities	107,814	110,634	110,342	97,818	94,674
Tax-exempt securities	5,404	4,543	3,135	3,298	2,080
Total interest income	665,781	596,354	591,810	655,276	651,159
Interest paid:					
Savings deposits	15,680	16,520	25,536	39,993	48,362
Time deposits	67,723	76,670	97,033	159,710	134,086
Total interest-bearing deposits	83,403	93,190	122,569	199,703	182,448
Short-term borrowings	7,844	5,604	11,259	25,120	48,711
Long-term debt	22,009	18,451	10,754	6,702	5,951
Total interest expense	113,256	117,245	144,582	231,525	237,110
Net interest income	\$ 552,525	\$ 479,109	\$ 447,228	\$ 423,751	\$ 414,049



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

I. EXECUTIVE OVERVIEW

Mercantile Bankshares Corporation ( Bankshares ) is a regional multibank holding company headquartered in Baltimore, Maryland. At December 31, 2004, Bankshares had \$14.4 billion in assets, \$10.2 billion in loans and \$10.8 billion in deposits. The two principal lines of business are Banking and Investment & Wealth Management ( IWM ), delivered through the lead bank Mercantile-Safe Deposit and Trust Company ( MSD&T ) and 12 affiliated banks. See Segment Reporting below for more information.

Bankshares recorded its 29<sup>th</sup> consecutive year of increased net income in 2004. Net income for Bankshares was \$229.4 million for the year ended December 31, 2004, compared with \$196.8 million for the year 2003. Diluted net income per common share for 2004 increased by 7.1% to \$2.87 compared with \$2.68 for 2003. The most noteworthy factors affecting 2004 earnings were the successful integration of F&M Bancorp ( Farmers ), the consolidation of 11 bank affiliates into four ( the Affiliate Bank Rationalization ), improvement in the net interest margin, growth in loans, improving credit quality and improved profit contribution from the IWM division.

On August 12, 2003, Bankshares completed its acquisition of Farmers, a bank holding company headquartered in Frederick, Maryland. On the date of purchase, Farmers had total loans of \$1.4 billion, total investment securities of \$638.0 million, total earning assets of \$2.0 billion and total deposits of \$1.7 billion. There were 10.4 million shares issued in connection with the acquisition, which was accounted for as a purchase and resulted in total consideration paid of \$558.1 million (including the cash component). Farmers is the second largest affiliate bank in the organization behind only MSD&T in total assets. The results of operations and balances for Farmers are included in the consolidated financial statements from the merger date forward. Bankshares recorded \$385.9 million of goodwill, \$36.0 million of core deposit intangible, \$5.8 million of client relationship intangibles and \$1.1 million in other identified intangible assets.

In the third quarter of 2004, Bankshares consolidated 11 affiliate banks into four banks. The consolidated banks shared common markets. The consolidation of these banks allows the surviving banks to serve their local customers with greater size, scale and expertise. This initiative was not undertaken to reduce operating costs, although some savings will arise out of the consolidation. It was to enable these banks to streamline operating processes, controls and compliance efforts; recruit seasoned professionals to these markets; and provide a greater breadth of services at the local level. Bankshares is highly committed to the affiliate bank model, whereby local boards of directors provide strong oversight, and bank presidents maintain strong relationships within the community. As with any strategic initiative there are costs involved. In 2004, Banking incurred approximately \$3.6 million in restructuring charges related to the consolidations. A majority of these costs were in severance charges and other personnel costs of approximately \$2.3 million and \$1.1 million in legal and consulting fees. Management expects to achieve cost savings of not less than \$3 million in 2005.

In response to the improving economy, the Board of Governors of the Federal Reserve System ( Federal Reserve Board ) began increasing short-term interest rates. After reducing short-term rates by 50 basis points in 2002 and 25 basis points in 2003, the Federal Reserve Board increased short-term rates 125 basis points in 2004. By year-end 2004, the benchmark targeted overnight federal funds rate had risen from 1.00% to 2.25%. Although the net interest margin improved only 3 basis points to 4.35% for 2004 from 4.32% for 2003, this compares very favorably with the 33 basis point decline experienced during 2003. The net interest margin for 2002 was 4.65%. Most economists are forecasting that the Federal Reserve Board will continue to raise short-term rates during 2005. If these forecasts are correct, Bankshares should benefit from such action. See Analysis of Interest Rate and Interest Differentials below and the discussions of Net Interest Income and Interest Rate Risk below.

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At December 31, 2004, loans outstanding were \$10.2 billion, an increase of 10.3% over the \$9.3 billion outstanding at December 31, 2003. Excluding initial balances acquired in acquisitions, this was the best year-end loan growth Bankshares has reported since year-end December 31, 2000. Much of the lending growth has been driven by the strong real estate markets in both commercial and residential properties. An improving economy also produced positive growth in the commercial and industrial portfolio.

Credit quality measures improved on both an absolute and relative basis. Nonperforming loans declined from \$50.4 million a year ago to \$30.9 million at December 31, 2004. This is the lowest level reported at year-end since December 31, 2000. Nonperforming loans as a percent of year-end loans were .30% at December 31, 2004. This is the lowest level at year-end in more than 20 years. Reflecting these improvements, the provision for loan losses declined by \$4.9 million to \$7.2 million for the year ended December 31, 2004.

The IWM Division includes the results from Boyd Watterson Asset Management, LLC ( Boyd Watterson ), an investment management firm, and Peremel & Company, Inc. ( Peremel ), a directed and discount brokerage company, acquired on March 1, 2003 and April 1, 2003, respectively. In the aggregate, these companies were purchased for approximately \$29 million in cash. The Boyd Watterson acquisition has a potential additional contingent payment of up to \$8.6 million based upon performance, among other factors. The contingent payment will be recorded as goodwill, assuming specific metrics are met, and becomes payable three years

from the acquisition date. Bankshares recorded approximately \$10.1 million of identified intangibles, mostly client relationships, as a result of these acquisitions. These intangibles are amortized on a straight-line basis over a range of three to eight years. Goodwill recorded on these transactions totaled approximately \$18.0 million at December 31, 2004. A combination of net new business and improving equity markets produced a 15% increase in IWM noninterest income. See Segment Reporting below for additional information. At the same time, growth in direct noninterest expense was held to 3%. Accordingly, the contribution to net income more than doubled to \$11.6 million in 2004, from \$5.1 million in 2003.

The year 2004 proved to be another year of relatively solid performance, as indicated by the standard industry measures of return on average assets ( ROA ) and return on average shareholders' equity ( ROE ). The 2004 ROA was 1.64%, unchanged from 2003. Primarily due to the equity issued in the Farmers acquisition, Bankshares' 2004 ROE decreased to 12.26% from 13.15% in 2003. Average assets increased by 16.9%, or \$2.0 billion; average deposits increased by 15.8%, or \$1.4 billion; and average loans increased by 20.2%, or \$1.6 billion, for the year ended December 31, 2004 compared with the prior year. The respective increases in the 2004 average balances are largely attributable to the inclusion of Farmers for a full year. Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities' operations into Bankshares) unrelated to Bankshares' core operations. Cash operating earnings totaled \$235.5 million for 2004, an increase of 17.7% over \$200.2 million for 2003. Diluted cash operating earnings per share for 2004 were \$2.95 compared with \$2.73 for 2003. A reconciliation of GAAP basis net income to cash operating earnings can be found below under Non-GAAP Reconciliation.

Average shareholders' equity to average assets was at 13.38% for 2004, an increase from 12.51% for 2003. In the second quarter of 2004, 1 million shares at a cost of \$44.1 million were repurchased under Bankshares' buyback plan. The buyback was accomplished by entering into a privately negotiated agreement for the accelerated repurchase of these shares. In 2003, 5,500 shares were repurchased in the open market. At December 31, 2004, Bankshares had remaining authorization to repurchase up to 476,327 shares.

Management believes that reporting several key measures based on tangible assets (total assets less intangible assets) and tangible equity (total equity less intangible assets) is important, as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes. For the year 2004, return on average tangible assets was 1.75% compared with 1.71% for 2003. The ratio of average tangible equity to average tangible assets for 2004 was 9.70% compared with 10.34% for 2003. The decline in average tangible equity to average tangible assets was largely attributable to the use of \$124.1 million of cash (or 25% of the consideration paid) to acquire Farmers. A reconciliation of GAAP to non-GAAP measures is below. See Non-GAAP Reconciliation.

The remaining sections of Management's Discussion and Analysis of Financial Condition and Results of Operations will provide a more detailed explanation of the important trends and material changes in components of our financial statements. The discussion suggests that sustaining future earnings growth comparable to our experience in past years will require, among other things, efficient generation of loan growth in a competitive market, while maintaining an adequate spread between yields on earning assets and the cost of funds. Our degree of success in meeting these goals depends on unpredictable factors such as possible changes in prevailing interest rates, the mix of deposits, credit quality and general economic conditions. This discussion and analysis should be read in conjunction with the consolidated financial statements and other financial information presented in this report.

## NET INCOME

(Dollars in millions)

Five-Year Compound Growth Rate: 7.8%

DILUTED EARNINGS PER SHARE

(In dollars)

Five-Year Compound Growth Rate: 5.0%

TOTAL ASSETS

(Dollars in millions) December 31,

Five-Year Compound Growth Rate: 12.8%

INTEREST YIELDS AND RATES

(Tax-equivalent basis)

**Critical Accounting Policies and Related Estimates**

Set forth below is a discussion of the accounting policies and related estimates that management believes are the most critical to understanding Bankshares' consolidated financial statements, financial condition and results of operations, and which require complex management judgments, uncertainties and/or estimates. Information regarding Bankshares' other accounting policies is included in Note No. 1 of the financial statements.

*Investment Securities*

Investment securities classified as held-to-maturity are acquired with the intent and ability to hold until maturity and are carried at cost. Investment securities classified as available-for-sale are acquired to be held for indefinite periods of time and may be sold in response to changes in interest rates and/or prepayment risk or for liquidity management purposes. These securities are carried at fair value. Securities may become impaired on an other-than-temporary basis, which involves a degree of judgment. Therefore, an assessment is made at the end of each quarter to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. An other-than-temporary impairment may develop if, based on all available evidence, the carrying amount of the investment is not recoverable within a reasonable period of time. Factors considered in making this assessment include among others, the intent and ability to hold the investment for a period of time sufficient for a recovery in value, external credit ratings and recent downgrades, market price fluctuations due to factors other than interest rates, and the probability of collection of contractual cash flows. Securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value, and the adjustment is recorded as a realized loss.

*Allowance for Loan Losses*

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. Bankshares' allowance for loan losses provides for probable losses based on evaluations of known and inherent risks in the loan portfolio. Management uses historical quantitative information to assess the adequacy of the allowance for loan losses as well as qualitative information about the prevailing economic and business environment among other things. The allowance for loan losses is comprised of specific allocations to impaired loans, general allocations to pools of loans not deemed impaired and an unallocated amount.

The specific allowance allocation is based on an analysis of the loan portfolio. Each loan with an outstanding balance in excess of a specified threshold that is either on nonaccrual status or on the Watchlist is evaluated. The Watchlist represents loans identified and closely followed by management. They possess certain qualities or characteristics that may lead to collection and loss issues. The identified loans are evaluated for potential loss in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114 and SFAS No. 118 by analyzing current collateral values or present value of cash flows, as well as the capacity of the guarantor, as applicable.

The general allowance calculation begins with segmentation of the remaining (unimpaired) portfolio according to loan types. Historical loss factors are maintained for each loan type, providing the starting point of the analysis. Historical loss factors are applied to all non-Watchlist loans. Management is currently utilizing the past five-year loss history specific to each major segment to perform the allocation. Historical loss factors are adjusted to reflect the point in time that management initially identified a potential impairment loss in such risk-rated loans as opposed to when such loss is actually taken as a charge-off against the allowance. This adjustment is necessary, as Bankshares' practice has generally been to work with its borrowers through their economic difficulties and record a charge-off when all recovery efforts have been exhausted. Accordingly, historical losses may tend to lag the national and regional economic cycles. Bankshares also has developed data on probability of default and loss given default, which have been incorporated for the higher risk rated credits, which include Watchlist loans that are not currently impaired. Those loss factors are then applied to all loans within the same risk rating. Qualitative factors that may cause credit losses to deviate from average historical experience are then developed. These include but are not limited to: changes in the volume and severity of past due loans; changes in the volume of Watchlist loans and nonaccruals; concentrations in a specific industry or geographic location; administrative risk concerns that include changes in the loan review and loan grading system; changes in lending policies and procedures (which include

underwriting, collection, charge-off and recovery practices); changes in management or the staff of any previously mentioned areas; and current economic conditions and indicators. Both internal and external peer data are utilized as applicable to establish these factors. Management's judgment and experience are key to this process. These factors are revised to address current conditions and trends in the portfolio.

The allowance amount not allocated represents the differential between the combined specific and general allocations and the actual allowance. The unallocated allowance recognizes the imprecision inherent in estimating and measuring loss when allocating the allowance to individual or pools of loans. It also takes into consideration the allowance level deemed appropriate by each affiliate based on its local knowledge and feedback from Bank regulators and their view from the standpoint of safety and soundness, among other factors.

For a full discussion of Bankshares' methodology for assessing the adequacy of the allowance for loan losses, see Allowance for Loan Losses below and Note No. 1 of the financial statements.

#### *Loans on Nonaccrual Status or Deemed to Be Impaired*

A loan asset will be classified and placed into nonaccrual status when the principal or interest payments on any loan (e.g., commercial, mortgage and construction loans) are past due 90 days or more at the end of a calendar quarter and/or the payment in full of principal or interest is not expected. Any accrued but uncollected interest is reversed at that time. Consumer installment loans are charged off when they become 90 days past due. Additionally, a loan may be put on nonaccrual status sooner than 90 days, if in management's judgment, the loan or portions thereof are deemed uncollectible. Bankshares ceases to accrue interest income on such loans. Subsequent receipts on nonaccrual loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Generally a loan may be restored to accruing status when all past due principal, interest and late charges have been paid and the bank expects repayment of the remaining contractual principal and interest.

A loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. A majority of Bankshares' impaired loans are measured by reference to the fair value of the collateral.

#### *Income Taxes*

Bankshares recognizes deferred income tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryovers and tax credits. Deferred tax assets are subject to management's judgment, based on available evidence, that future realization is more likely than not. If management determines that Bankshares may be unable to realize all or part of net deferred tax assets in the future, then Bankshares would be required to record a valuation allowance against such deferred tax asset. In such an event, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount. Although management has determined that a valuation allowance is not currently required, no assurance can be given that one will not be required in the future. For more information regarding Bankshares' accounting for income taxes, see Note No. 12 of the financial statements.

*Valuation of Goodwill/Intangible Assets and Analysis for Impairment*

Bankshares has increased its market share, in part, through the acquisition of entire financial institutions accounted for under the purchase method of accounting, as well as from the purchase of other financial institutions' branches (not the entire institution). Bankshares is required to record assets acquired and liabilities assumed at their fair value, which involves an estimate determined by the use of internal or other valuation techniques. See Note No. 19 of the financial statements for further information on the accounting for goodwill and other intangible assets.

II. ANALYSIS OF OPERATING RESULTS FOR 2004 TO 2003

**Segment Reporting**

Bankshares has historically identified three distinct business segments for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. This segmentation is consistent with the reporting structure established at the time Bankshares was formed. At that time the organization consisted of: a lead bank, MSD&T, with two business segments Banking and Investment & Wealth Management ( IWM ); and a Community Bank segment, which has been built through acquisitions and continued operation of independent charters. With the Farmers acquisition in 2003 and the consolidation of 11 affiliate banks into four banks in 2004, the distinction between banking segments has become less apparent. Increased lending authority at the Banks has resulted in additional loan growth within their market areas and reduced referral and overline business to MSD&T. As a result of the convergence of the two banking segments, Bankshares currently reports these segments collectively as Banking. The Banking segment consists of the group of 13 affiliate banks. Mortgage banking activities are



not viewed as a separate business line due to the insignificant impact on the core business of Bankshares and, accordingly, are included in the Banking segment. A schedule disclosing the details of these operating segments can be found in Note No. 16 of the financial statements. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares consolidated results. Certain expense amounts, such as operations overhead, have been reclassified from internal financial reporting in order to provide for proper allocation of costs in the reported data.

*Banking*

The Banking segment includes the Retail, Small Business, Commercial and Mortgage Banking lines of business. Banking products include:

**Retail Banking:** Checking, savings and money market accounts, time deposits and IRAs, insurance, equity lines and loans, lines of credit, and equipment and transportation (auto, recreational vehicle and marine) loans.

**Small Business Banking:** Deposit and credit products and services to businesses with annual revenues up to \$3 million or credit needs up to \$750 thousand, including receivables and inventory financing, equipment leases, and real estate financing.

**Commercial Banking:** Commercial deposit, lending and commercial real estate solutions to businesses typically with annual revenues between \$4 million and \$50 million, and including commercial loans and lines of credit, letters of credit, asset-based lending, commercial real estate, construction loans and capital market products.

**Mortgage Banking:** residential mortgage loan origination, construction and servicing.

In the third quarter of 2004, Bankshares consolidated 11 affiliate banks into four banks. The consolidated banks shared common markets. The consolidation of these banks allows the surviving banks to serve their local customers with greater size, scale and expertise. This initiative was not undertaken to reduce operating costs, although some savings will arise out of the consolidation. It was to enable these banks to streamline operating processes, controls and compliance efforts; recruit seasoned professionals to these markets; and provide a greater breadth of services at the local level. Bankshares is highly committed to the affiliate bank model, whereby local boards of directors provide strong oversight, and bank presidents maintain strong relationships within the community. As with any strategic initiative there are costs involved. In 2004, Banking incurred approximately \$3.6 million in restructuring charges related to the consolidations. A majority of these costs were in severance charges and other personnel costs of approximately \$2.3 million and \$1.1 million in legal and consulting fees. Management expects to achieve cost savings of not less than \$3 million in 2005.

2004 (Dollars in thousands)	Banking	IWM	Other	Total
Net interest income	\$ 544,640	\$	\$ 1,141	\$ 545,781
Provision for loan losses	(7,221)			(7,221)

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Noninterest income	114,477	90,516	8,936	213,929
Noninterest expenses	(319,540)	(68,741)	(3,677)	(391,958)
Adjustments	18,098	(3,603)	(14,495)	
Income (loss) before income taxes	350,454	18,172	(8,095)	360,531
Income tax (expense) benefit	(127,462)	(6,609)	2,947	(131,124)
Net income (loss)	\$ 222,992	\$ 11,563	\$ (5,148)	\$ 229,407
Average loans	\$ 9,719,249		\$ 160	\$ 9,719,409
Average earning assets	12,704,204		28,800	12,733,004
Average assets	13,541,941		451,030	13,992,971
Average deposits	10,498,445		(84,753)	10,413,692
Average equity	1,480,574		391,096	1,871,670

2003 (Dollars in thousands)	Banking	IWM	Other	Total
Net interest income	\$ 477,507	\$	\$ (5,158)	\$ 472,349
Provision for loan losses	(12,105)			(12,105)
Noninterest income	98,426	78,608	6,538	183,572
Noninterest expenses	(265,893)	(66,633)	(4,921)	(337,447)
Adjustments	9,941	(3,483)	(6,458)	
Income (loss) before income taxes	307,876	8,492	(9,999)	306,369
Income tax (expense) benefit	(107,743)	(3,397)	1,585	(109,555)
Net income (loss)	\$ 200,133	\$ 5,095	\$ (8,414)	\$ 196,814
Average loans	\$ 8,088,749		\$ 233	\$ 8,088,982
Average earning assets	11,086,263		11,225	11,097,488
Average assets	11,701,443		270,138	11,971,581
Average deposits	9,142,644		(150,790)	8,991,854
Average equity	1,309,477		187,668	1,497,145

The addition of Farmers during 2003 had a significant impact on nearly every line of the consolidated balance sheet and statement of consolidated income as well as the performance of the Banking segment, as set forth below. Net income for Banking for 2004 increased 11.4% to \$223.0 million, from \$200.1 million for 2003. Net interest income for Banking increased 14.1% to \$544.6 million for 2004 from \$477.5 million for 2003. The growth in net interest income in 2004 reflected a 14.6% increase in average earning assets, which more than offset a 4 basis point decline in the net interest margin from 4.38% in 2003 to 4.34% in 2004. Contributing to the net interest margin decline was the capital restructuring of the Banks during the third quarter of last year. Subordinated debt totaling \$300 million, issued by Bankshares in April 2003, and used in part to fund the cash portion of the Farmers acquisition, was invested in a like amount of subordinated debt issued by the Banks. Excess equity capital was paid to Bankshares in the form of a special cash dividend.

As a reflection of the overall improvement in the Banking credit quality trends, Banking recorded a decrease of \$4.9 million in the provision for loan losses for 2004. Banking recorded a provision for loan losses of \$7.2 million in 2004 compared with \$12.1 million in 2003. The allowance as a percent of loans was 1.46% at year-end 2004 compared with 1.68% at year-end 2003.

Average assets for Banking increased 15.7% to \$13.5 billion in 2004. Average investments and loans increased 7.0% and 20.2%, respectively, while other assets accounted for the balance of the increase in average assets. Average deposits for Banking increased 14.8% to \$10.5 billion in 2004. The growth in the Banking average balances was due primarily to the Farmers acquisition.

In 2004, commercial loans, including commercial mortgages, accounted for 58.2% of Banking's average total loans, slightly lower than the 59.3% for 2003. These loans increased 17.9% from the 2003 average. Construction and consumer loans accounted for approximately the same portion of loans in 2004 as in 2003, at 27.0% and 26.2%, respectively. Construction loans increased 23.0%, while consumer loans increased 23.9%, from 2003 levels. Residential real estate loans, which were 14.8% and 14.5% of average total loans for 2004 and 2003, respectively, increased 23.3%.

At December 31, 2004, noninterest-bearing deposits accounted for 27.5% of Banking's average total deposits, slightly higher than the 25.0% in 2003. These deposits increased 26.6% from the 2003 average. Savings, interest checking and money market accounts accounted for 40.8% of Banking's average total deposits, compared with 39.4% in 2003. Savings deposits increased 22.0%, interest-bearing checking deposits increased 20.3% and money market deposits increased 15.8% from 2003. Certificates of deposit represented 31.7% of total deposits, down slightly from 35.6% in 2003.

The year-over-year increases in noninterest income and noninterest expenses from 2003 are attributable primarily to the Farmers acquisition and branch expansion programs. Noninterest income increased by \$16.1 million, with deposit service charges increasing by \$5.1 million, insurance fees increasing by \$8.7 million and electronic banking fees increasing by \$4.8 million, accounting for the largest gains. These gains were partially offset by a decrease of \$6.8 million in net gains on investment securities sold. Noninterest expenses increased by \$53.6 million from 2003. More than 72% of this increase is related to salaries and benefits, which grew by \$32.7 million. Severance costs related to the affiliate bank consolidations were approximately \$2.3 million. Occupancy expense increased by \$3.1 million, and amortization of intangible assets increased by \$2.6 million, while furniture and equipment expenses decreased by \$1.3 million.

#### *Investment & Wealth Management*

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

Retail Brokerage Services: Stocks, bonds, proprietary and nonproprietary mutual funds, fixed and variable annuities.

Asset Management Services: Proprietary and nonproprietary mutual funds, proprietary and nonproprietary separate account management, customized wealth advisory services, defined benefit and defined contribution retirement services, family office services, individual and institutional trust services and custody services.

Private Banking Services: Deposits, loans and mortgages.

On November 12, 2004, Bankshares consolidated its brokerage activities by merging Mercantile Securities, Inc., into Peremel. The resulting entity is called Mercantile Brokerage Services, Inc., a general securities broker-dealer that offers full-service, discount and online brokerage services.

Continued progress was made in growing the IWM business and enhancing client services. Resources related to distribution were added within IWM as well as the affiliate Banks, including the addition of a small team of financial advisors. Improvements were made in client reporting. Effective January 1, 2005, IWM converted its trust accounting platform to SunGard Wealth Management Systems.

Net income in IWM increased to \$11.6 million in 2004, from \$5.1 million in 2003. Pretax profit margins, prior to corporate overhead allocations, were 24.1% and 15.2% for 2004 and 2003, respectively. For more information on corporate overhead see Other in

Segment Reporting below.

At December 31, 2004, assets under administration by IWM were \$47.8 billion, an increase of \$1.8 billion from the prior year. Bankshares had investment management responsibility for \$22.0 billion, up \$0.8 billion from the prior year.

Revenues increased \$11.9 million, or 15.1%, to \$90.5 million in 2004 from \$78.6 million in 2003. Revenue increases were achieved in the three principal client segments: private wealth, institutional and brokerage. Growth in IWM revenues was due principally to stronger markets during 2004 than 2003, new business development efforts and the inclusion of a full year's results from Boyd Watterson and Peremel, which were acquired on March 1, 2003 and April 1, 2003, respectively. Together, these acquisitions accounted for \$2.4 million of the increase in revenues.

The improved performance in equity markets that began in the second quarter of 2003 had a positive impact on IWM revenues throughout 2004. Slightly more than 40% of IWM's managed assets is invested in equities, including real estate. Approximately one-third is invested in fixed income securities and just above 20% is invested in short-term money market investments. Between December 31, 2003 and December 31, 2004, all major equity indices rose. The S&P 500 index was up 9%, the Dow Jones Industrial Average was up 4% and the Nasdaq was up 30%.

Gross new assets from new business development efforts exceeded \$925 million, up approximately 8% from 2003. All client segments contributed to this growth, with institutional real estate and brokerage showing the highest growth rates. Revenues related to gross new assets were partially offset by higher levels of terminating accounts in the Private Wealth Management segment. Also contributing to revenue growth during 2004 were increases in and the performance of the three hedge funds of funds ( hedge funds ).

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

Expenses increased 3.2% to \$68.7 million in 2004. Increases in legal and professional service expenses were offset largely by decreases in personnel-related and technology expenses. Also contributing to the increase was the inclusion of a full year's results for Boyd Watterson and Peremel. Excluding the impact of the acquisitions, expenses fell 1.4%, or \$0.8 million. Expenses for 2003 included \$3.6 million of severance and \$0.5 million paid to terminate a technology equipment lease.

During the first quarter of 2004, Bankshares entered into a seven-year service contract with SunGard Wealth Management Services to provide a new core accounting system and back-office operations beginning in January 2005. Year-to-date, IWM has incurred approximately \$0.9 million in restructuring charges related to the conversion to SunGard's AddVantage trust accounting system. A majority of these costs were severance charges of approximately \$0.6 million. Conversion costs of approximately \$1.8 million that were incurred in 2004 are being amortized over the life of the contract.

*Other*

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The components in the Other column consist of amounts for the nonbanking affiliates, unallocated corporate expenses and intercompany eliminations.

Net interest income increased \$6.3 million due to a full year of intercompany income related to the subordinated debt referred to in the Banking section. Noninterest income increased \$2.4 million related to income from private equity investments.

The adjustments line, which represents corporate allocations from the lead Bank (MSD&T), increased \$8.0 million in 2004 over 2003. This increase is due mostly to allocations related to Sarbanes-Oxley compliance and increased staffing in corporate support functions.

ANALYSIS OF INTEREST RATES AND INTEREST DIFFERENTIALS

The following table presents the distribution of the average consolidated balance sheets, interest income/expense and annualized yields earned and rates paid.

**2004**

**2003**

**&**