MERCANTILE BANKSHARES CORP
Form 10-K
March 12, 2004

United States
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2003

OR

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

For the transition period from __________ to __________

Commission file number 0-5127

Mercantile Bankshares Corporation

(Exact name of registrant as specified in its charter)

Maryland	52-0898572
State or other jurisdiction of incorporation or organization	(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
(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 **X** No ___

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes **X** No ___

At June 30, 2003, 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 (including fiduciary accounts administered by affiliates) was $2,718,819,545 based on the last sale price on the Nasdaq National Market on June 30, 2003.

As of February 27, 2004, 79,895,736 shares of common stock were outstanding.

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.

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 $13.7 billion in assets for the year ended December 31, 2003, is a regional multibank holding company with headquarters in Baltimore, Maryland. It is comprised of Mercantile-Safe Deposit and Trust Company (MSD&T) and 19 community banks (each a Community Bank) and a mortgage banking company. Sixteen banks are located in Maryland, three are in Virginia and one is in southern Delaware. Bankshares largest bank, MSD&T, represents approximately 33% of total assets and operates 24 offices in Maryland, one office in Washington, D.C., and one commercial office in Pennsylvania.

On August 12, 2003, Bankshares acquired F&M Bancorp (F&M) for a mix of cash and stock for total consideration of $558.1 million. On the date of purchase, F&M had total loans of $1.4 billion, total assets of $2.2 billion and total deposits of $1.7 billion. In late October, certain assets and liabilities from F&M were allocated to MSD&T and certain Community Banks whose market places overlapped with F&M.

Nearly all of Bankshares substantial trust operations and specialized corporate banking services are provided by MSD&T.

Bankshares places particular emphasis on long-term customer relationships by providing value-added services through its extensive Community Bank network. Each Community Bank has its own name, 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 MSD&T and the 19 Community Banks and directly or indirectly owns all of the outstanding stock of certain other affiliates. For purposes of segment reporting, three operating components have been identified. They are the banking division of the lead bank, MSD&T; the Investment and Wealth Management Division of MSD&T; and the 19 Community Banks. The principal components of our banking and non-banking network are listed below.

Lead Bank and Affiliates

Mercantile-Safe Deposit and Trust Company	Baltimore, Maryland
Mercantile Mortgage Corporation	
Mercantile Agency, Inc.	
Mercantile Capital Advisors, Inc.	
Mercantile Securities, Inc.	
Mercantile/Cleveland, LLC	
Peremel & Co., Inc.**	
Boyd Watterson Asset Management, LLC*	
MBC Agency, Inc.	
Mercantile Life Insurance Company	
MBC Realty, LLC	

* 100% interest in Boyd Watterson was acquired on February 28, 2003

** Bankshares acquired a 100% interest in Peremel on March 31, 2003

Community Banks

The Annapolis Banking and Trust Company	Annapolis, Maryland
Bank of Southern Maryland	LaPlata, Maryland
Calvert Bank and Trust Company	Prince Frederick, Maryland
The Chestertown Bank of Maryland	Chestertown, Maryland
The Citizens National Bank	Laurel, Maryland
County Banking & Trust Company	Elkton, Maryland
Farmers & Mechanics Bank	Frederick, Maryland
The Fidelity Bank	Hagerstown, Maryland
The First National Bank of St. Mary s	Leonardtown, Maryland
The Forest Hill State Bank	Bel Air, Maryland
Peninsula Bank	Princess Anne, Maryland
The Peoples Bank of Maryland	Denton, Maryland
Potomac Valley Bank	Gaithersburg, Maryland
St. Michaels Bank	St. Michaels, Maryland
Westminster Union Bank	Westminster, Maryland
Baltimore Trust Company	Selbyville, Delaware
Farmers & Merchants Bank Eastern Shore	Onley, Virginia
The National Bank of Fredericksburg	Fredericksburg, Virginia
Marshall National Bank and Trust Company	Marshall, Virginia

For segment reporting information, see Footnote 15 to the financial statements in Item 8 hereof, and information under the heading Segment Reporting in the sections captioned Analysis of Operating Results for 2003 to 2002 and Review of Earnings and Balance Sheet for 2002 to 2001, in Item 7 hereof.

Bankshares periodically reviews and considers possible acquisitions of banks and other entities performing related activities and discusses such possible acquisitions with managements 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

MSD&T and all of the Community 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 indexed money market account. The banks offer home equity loans and lines of credit, as well as installment loans, to meet a variety of borrowing needs.

The Community Bank network provides customers with no-fee access to 235 ATMs, and customers can perform many routine transactions at any of the 227 bank 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® enables customers to access their personal accounts online to verify account balances, track recent account activity and perform selected transactions. Recently, online banking was enhanced with bill payment capabilities. Banking Twenty-Four offers sole proprietors similar and specifically tailored capabilities to meet their small business needs.

Home Mortgages

Residential mortgages are provided through Mercantile Mortgage LLC, a joint venture between Mercantile Mortgage Corporation (Mercantile Mortgage), a subsidiary 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 Community 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 lessened through underwriting procedures and credit quality standards, among other things.

Commercial Banking Services

Lending

General Commercial Lending

With their local knowledge and focus, our Community 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 purposes, such as working capital, plant expansion or equipment purchases, and for financing industrial and commercial real estate. Where appropriate, the banks employ 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 Community Banks when their customers credit needs exceed the Community 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 other Community Banks to arrange more sophisticated financing in the areas of acquisitions and management buyouts.

Real Estate Lending

The Real Estate Group at MSD&T provides land acquisition and development, construction and interim financing to commercial real estate investors and developers. The Community Banks also provide such lending to their customers in their markets. Credits exceeding a predetermined threshold are made in collaboration with the Real Estate Lending Group.

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

Mercantile Mortgage also provides permanent financing for multifamily projects as one of the nation s few Fannie Mae Delegated Underwriting and Servicing lenders. Permanent financing for multifamily projects and long-term, nonrecourse financing for commercial real estate are provided through Columbia National Real Estate Finance LLC, a subsidiary of Mercantile Mortgage. Columbia National is a Freddie Mac Program Plus Seller Servicer. It has correspondent relationships with approximately 12 life insurance companies and services a loan portfolio in excess of $5.3 billion.

Managing Credit Risk

Much of the fundamental business of Bankshares is based on understanding, measuring and controlling credit risk. Credit risk includes both general risks, which are part of the lending process, and specific risk relating to each borrower. With respect to commercial lending, losses as a percentage of outstanding loans can vary widely from period to period and are particularly sensitive to changing economic conditions. MSD&T and each Community Bank carefully evaluate the credit risk presented by a customer and often require collateral support as well as personal guarantees of the borrower. Bankshares and each

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Community Bank often have the benefit of long-standing customer relationships, which management believes is a key component to managing credit risk. The type of collateral support varies, but includes accounts receivable, inventory, land, buildings, equipment, income-generating commercial properties and residential real estate, among other things.

The evaluation of specific risk is a basic function of the underwriting and loan administration in each of our Community Banks, involving analysis of the borrower s ability to service debt as well as the value of pledged collateral.

Bankshares has established a centralized independent loan review function charged with regularly reviewing the loan portfolio and identifying changes in the economy or in a borrower s circumstances that may affect the ability to repay debt or the value of pledged collateral. On a regular basis senior management, through the establishment of a Credit Quality Committee, monitors the degree of risk in the loan portfolio. In addition, lenders assign a grade to each commercial loan based on a number of factors, including the borrower s capacity to service the debt and the presence and value of the collateral for the loan. The independent loan review function evaluates on a regular basis the grade assigned to certain loans and analyzes the impact on the allowance for loan losses.

Cash Management

Centered at MSD&T, Cash Management Services helps business customers of all Community Banks collect, transfer and invest their cash. Through a variety of electronic payment and account management tools, Cash Management also enables customers to monitor cash flows conveniently and efficiently. Nonprofit institutions such as unions, charities and philanthropic organizations also use Cash Management services.

Private Equity

Bankshares, in partnership with MSD&T, began a focused private equity investment initiative in 2000 as an alternative use of capital with the objectives of generating long-term returns and developing additional long-term client relationships with emerging companies in Bankshares footprint. The primary investments are capital commitments to 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 would likely be, in time, potential Bankshares customers. For more information on private equity investments see Footnote No. 9 of the financial statements.

Investment And Wealth Management Services

Bankshares offers investment and wealth management services through MSD&T and continues building on a 140-year tradition of providing investment and wealth management services to private individuals, family groups and institutions.

Today, Bankshares provides a range of wealth management services. An open architecture platform gives clients access to proprietary investment management in addition to carefully selected outside managers. Both the open architecture platform and proprietary investment management offer clients a comprehensive approach to equity and fixed-income investments complemented by alternative investments. Bankshares proprietary investment platform includes both separate account management and mutual funds, including the Mercantile Dow Jones U.S. Portfolio Funds, based on the Dow Jones Portfolio Indexes. Investment and wealth management services are available throughout the Community Bank network, Cleveland-based Boyd Watterson Asset Management LLC (Boyd Watterson) and Baltimore-based Peremel & Company, Inc. (Peremel). Peremel fills an important niche by offering brokerage capabilities and account services. At December 31, 2003, Bankshares had $22 billion of discretionary assets under management and $46 billion of 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 investors, working in partnership with our clients, provide access to the Mercantile funds, separately managed accounts, nonproprietary mutual funds and a variety of alternative investments. With the acquisition of Peremel, our clients have access to full-service brokerage capabilities. MSD&T provides a wide range of 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. MSD&T 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 means, the Family Office team works with more than 85 families whose total assets approach $5 billion. The Family Office is comprised of professionals including CFAs, CFPs and attorneys. The group integrates the full range of services required to manage its clients complex, multigenerational financial circumstances. MSD&T 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 guidance in sophisticated, nontraditional investment strategies, 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 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 its Community Banks and Boyd Watterson, 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, corporations, unions, charitable organizations and military institutions. For example, MSD&T is trustee for a group trust that focuses on commercial real estate investments for Taft-Hartley pension plans. MSD&T 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, 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., Beltsville, Maryland, 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.

Other Nonbanking Affiliates

Mercantile Agency, Inc. acts as agent in the sale of fixed-rate annuities and offers variable-rate annuities with Mercantile Securities, Inc.

Mercantile Securities, Inc. is a general securities broker-dealer that facilitates purchases by bank customers of shares of the Mercantile family of funds and other securities and variable-rate annuities.

Peremel & Co., Inc. is a general securities broker-dealer that offers discount and online brokerage services.

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

Mercantile Capital Advisors, Inc. is a registered investment adviser that provides investment advisory and administrative services to investment companies, including the Mercantile family of 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 6 Deposits
(VI)	Return on Equity and Assets	Return on Equity and Assets (Item 6)
(VII)	Short-Term Borrowings	Notes to Financial Statements, Note 7

Employees

At December 31, 2003, Bankshares and its affiliates had approximately 1,068 officers and 2,497 other employees. Of these, MSD&T employed 536 officers and 681 other employees and the Community Banks had 529 officers and 1,794 other employees.

Competition

The banking business, in all of its phases, is highly competitive. Within their service areas, MSD&T and the 19 Community 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 now an established part of the competitive environment.

Bankshares is a financial holding company and is the largest independent bank holding company headquartered in Maryland. MSD&T is the sixth largest commercial bank in the state. During 2003, Bankshares also competed with Maryland-based bank subsidiaries of the third, fourth, ninth, thirteenth, and nineteenth largest bank holding companies in the United States as well as banking subsidiaries of other non-Maryland bank holding companies. Measured in terms of assets under management and administration, MSD&T believes it is one of the largest trust institutions in the southeastern United States. MSD&T and its subsidiaries (i.e., Boyd Watterson & Mercantile Capital Advisers, 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 MSD&T and the Community Banks. Mercantile Agency, Inc. commenced business in 1996 and is a small competitor in its area.

The 19 other Community Banks ranged in asset size from $108 million to $1.527 billion, at December 31, 2003. 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.

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, 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 firewall 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 greatly 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. 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, Bankshares bank subsidiaries have moved certain securities activities that have become subject to Securities and Exchange Commission regulation into separate securities subsidiaries or affiliates. For example, in 2001 MSD&T formed two new subsidiaries to 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 Securities, Inc. a registered broker-dealer that facilitates the purchase of shares of mutual funds by bank customers and may engage in certain other potential activities. (Hopkins Plaza Securities, Inc. changed its name to Mercantile Securities, Inc. effective December 1, 2003).

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, extends 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 have not yet been issued. However, the FACT Act requires regulations implementing the new provisions on sharing of sensitive medical information among affiliates to be finalized by June 4, 2004, and to become effective on the later of 90 days after the regulations are issued in final form or the effective date specified in such regulations. The FACT Act also specifies that the regulations implementing the restrictions on use of information obtained from an affiliate for marketing purposes must be final no later than September 4, 2004, and effective no later than six months after the regulations are issued in final form (i.e., possibly as late as March 4, 2005). 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.

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.

Other Regulatory Matters. 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. In addition, there are numerous federal and state laws and regulations which regulate the activities of Bankshares and its bank subsidiaries, including requirements and limitations relating to capital and reserve requirements, 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 laws and regulations to which Bankshares is subject are constantly under review by Congress, regulatory agencies and state legislatures. Information regarding capital requirements for bank holding companies and tables reflecting Bankshares s regulatory capital position at December 31, 2003 can be found in Footnote 10 to the financial statements.

Bankshares is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the holding company s common stock and interest on its debt. The payment of dividends by a subsidiary is subject to federal law restrictions as well as to the laws of the subsidiary s state of incorporation. 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.

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

Further, 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.

Community Banks

All Community Banks, with the exception of The Citizens National Bank, Baltimore Trust Company, Farmers & Merchants Bank Eastern Shore, The First National Bank of St. Mary s, The National Bank of Fredericksburg and Marshall National Bank and Trust Company are Maryland banks, subject to the banking laws of Maryland and to regulation 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 Federal Deposit Insurance Corporation (the FDIC).

In addition, The Annapolis Banking and Trust Company, The Forest Hill State Bank and St. Michaels Bank 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 First National Bank of St. Mary s, The National Bank of Fredericksburg and Marshall National Bank and Trust Company are national banks subject to regulation and regular examination by the office of the Comptroller of the Currency in addition to regulation and examination by the FDIC, which insures their deposits.

Farmers & Merchants Bank Eastern Shore is a Virginia bank, subject to the banking laws of Virginia and to regulation by its State Corporation Commission, which is required by statute to make at least one examination in every three-year period. Its deposits are insured by, and it is subject to certain provisions of Federal law and regulation and examination by the FDIC.

Baltimore Trust Company 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 of the Federal Reserve Act, which limit the amount of loans or extensions of credit to, and investments in, Bankshares and its nonbank affiliates by MSD&T and the Community Banks, and Section 23B of the Federal Reserve Act, which requires that transactions between MSD&T or the Community Banks and Bankshares and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates. Under the federal banking laws, the federal regulatory agencies have broad power to take prompt corrective action if a depository institution fails to maintain certain capital levels and there are circumstances under which Community Banks could be responsible to the FDIC for losses incurred by it with respect to other Community Banks.

Other Affiliates

As affiliates of Bankshares, the nonbank affiliates are subject to examination by the Federal Reserve Board and, as affiliates of the Community Banks, they are subject to examination by the FDIC, the Commissioner of Financial Regulation of Maryland and the office of the Comptroller of the Currency, 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., Mercantile Securities, Inc., Boyd Watterson and Peremel, are subject to regulation by the Securities and Exchange Commission and state securities law authorities, and Mercantile Securities, Inc. and Peremel 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 Securities, 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 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 F&M Bancorp may not be fully realized or may take longer to realize than expected; (7) F&M 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.

ITEM 2. PROPERTIES

The main offices of Bankshares and MSD&T are located in a 21-story building at Two Hopkins Plaza in Baltimore owned by MBC Realty, LLC, a wholly-owned subsidiary of Bankshares. At December 31, 2003, these offices occupied approximately 163,000 square feet. At December 31, 2003, MSD&T 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 MBC Realty, LLC. Of the 26 banking and bank-related offices occupied by MSD&T, seven are owned in fee, seven are owned subject to ground leases and 12 are leased with aggregate annual rentals of approximately $1,646,000, not including rentals for the main office and adjacent premises owned by MBC Realty, LLC.

Of the 201 banking offices, 106 are owned in fee, 24 are owned subject to ground leases and 71 are leased, with aggregate annual rentals of approximately $6,634,000 as of December 31, 2003.

ITEM 3. LEGAL PROCEEDINGS

There was no matter which is required to be disclosed in this Item 3 pursuant to the instructions contained in the form for this Report.

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

On October 22, 2003 Bankshares formed a holding company management committee comprised of the individuals listed below:

Name	Position	Age
Edward J. Kelly, III	Chairman, President and Chief Executive Officer	50
Alexander T. Mason	Vice Chairman, Bankshares	52
J. Marshall Reid (1)	President and Chief Operating Officer, MSD&T	58
Kenneth A. Bourne, Jr.	Executive Vice President, MSD&T	61
Peter W. Floeckher, Jr.	Executive Vice President, Bankshares	54
John J. Pileggi	Chief Executive Officer, Investment and Wealth Management	44
Terry L. Troupe	Chief Financial Officer, Bankshares	56
John L. Unger	General Counsel, Bankshares	50
Michael M. Paese	Chief Administrative Officer, Bankshares	36
Deborah A. Kakaris	Executive Vice President, MSD&T	40
Frank K. Turner	Executive Vice President, MSD&T	48
Priscilla S. Hoblitzell	Senior Vice President, Bankshares	43

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 Mercantile-Safe Deposit and Trust Company. 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 and is Bankshares Chief Risk 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 firms Global Industry Group practice.

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 19 Community Banks, which includes risk management, compliance and enhanced performance through coordinated sharing of best practices.

Mr. Pileggi joined Mercantile in 2001 as head of Mercantile Capital Advisors, Inc. and Mercantile Securities, Inc. Appointed Chief Executive Officer of Investment & Wealth Management in September, 2003, Mr. Pileggi has more than 20 years experience in retail and institutional financial services, including hedge funds and private equity.

Mr. Troupe has been Chief Financial Officer of Bankshares and MSD&T, and Treasurer of Bankshares, since September, 1996. He was Vice President and Chief Financial Officer of IREX Corporation, a specialty mechanical insulation contractor and distributor, from May, 1993 to May, 1996. Prior thereto, Mr. Troupe was Vice Chairman of Meridian Bankcorp, Inc.

Mr. Unger became General Counsel on March 23, 2002 and was elected Secretary of Bankshares and MSD&T 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. 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 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.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

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 on Form 10-K.

In December, 2003 one director of Bankshares received an aggregate of 377 shares of Bankshares common stock, at fair market value, in lieu of a cash retainer fee, under the Bankshares Retainer Plan for Non Employee Directors. The shares issuable under the Plan have not been registered under the Securities Act of 1933 in reliance on applicable exemptions. The only potential Plan participants are outside directors, currently 17 in number. The maximum number of shares (450,000) issuable over ten years under the Plan is less than 1% of the total shares outstanding. Bankshares common stock is actively traded on the Nasdaq National Market.

ITEM 6. SELECTED FINANCIAL DATA

Five-Year Statistical Summary

Years Ended December 31, *(Dollars in thousands)*	**2003**	2002	2001	2000	1999
AVERAGE BALANCE SHEET STATISTICS					
Loans:					
Commercial	**$ 4,795,334**	$4,283,322	$3,978,335	$3,534,898	$3,094,713
Construction	**929,939**	733,237	795,931	738,393	606,771
Residential real estate	**1,171,194**	1,072,297	1,059,798	950,531	874,947
Consumer	**1,192,515**	999,988	998,792	945,810	800,936
Total loans	**8,088,982**	7,088,844	6,832,856	6,169,632	5,377,367
Federal funds sold, et al	**250,462**	178,624	141,245	29,434	15,762
Securities:					
U.S. Government obligations	**1,731,032**	2,089,004	1,705,543	1,628,477	1,807,264
States and political subdivisions	**69,888**	38,799	40,359	25,170	12,024
Mortgage-backed securities	**927,235**	216,391	48,203	21,252	2,916
Other investments*	**124,009**	23,578	22,299	19,505	20,557
Total securities	**2,852,164**	2,367,772	1,816,404	1,694,404	1,842,761
Total earning assets	**$11,191,608**	$9,635,240	$8,790,505	$7,893,470	$7,235,890
Deposits:					
Noninterest-bearing deposits	**$ 2,269,720**	$1,856,706	$1,618,838	$1,438,578	$1,334,282
Savings deposits**	**3,597,185**	2,936,197	2,471,674	2,345,808	2,375,075
Time deposits	**3,124,949**	2,839,507	2,958,158	2,412,468	2,186,868
Total deposits	**$ 8,991,854**	$7,632,410	$7,048,670	$6,196,854	$5,896,225
Borrowed funds:					
Short-term borrowings	**$ 851,348**	$ 845,938	$ 744,907	$ 860,241	$ 594,106
Long-term debt	**517,386**	279,471	117,823	87,679	70,836

Total borrowed funds	**$ 1,368,734**	$1,125,409	$ 862,730	$ 947,920	$ 664,942
AVERAGE RATES ***					
Loans:					
Commercial	**5.77**%	6.51%	7.99%	9.14%	8.58%
Construction	**5.41**	6.09	7.96	9.66	9.03
Residential real estate	**6.46**	7.30	7.94	7.98	7.96
Consumer	**6.25**	7.12	8.28	8.70	8.50
Total loans	**5.90**	6.67	8.02	8.96	8.52
Federal funds sold, et al	**1.56**	2.92	4.38	6.31	4.95
Securities:					
U.S. Government obligations	**4.25**	4.67	5.48	5.67	5.65
States and political subdivisions	**6.50**	8.08	8.17	8.26	7.98
Mortgage-backed securities	**3.90**	5.59	7.47	7.48	5.69
Other investments*	**6.33**	5.99	7.48	8.51	9.44
Total securities	**4.29**	4.83	5.62	5.77	5.70
Composite rate earned	**5.39**%	6.15%	7.46%	8.26%	7.79%
Deposits:					
Savings deposits**	**.46**%	.87%	1.62%	2.06%	2.04%
Time deposits	**2.45**	3.42	5.40	5.56	5.01
Total interest-bearing deposits	**1.39**	2.12	3.68	3.83	3.46
Borrowed funds:					
Short-term borrowings	**.66**	1.33	3.37	5.66	4.59
Long-term debt	**3.57**	3.85	5.69	6.79	6.80
Total borrowed funds	**1.76**	1.96	3.69	5.77	4.83
Composite rate paid	**1.45**%	2.10%	3.68%	4.16%	3.64%

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

Years Ended December 31, *(Dollars in thousands)*	**2003**	2002	2001	2000	1999
RETURN ON EQUITY AND ASSETS					
Average total assets	**$11,971,581**	$10,123,457	$9,227,202	$8,299,316	$7,628,660
Average shareholders equity	**$ 1,497,145**	$ 1,257,967	$1,197,058	$1,054,071	$ 971,837
Return on average total assets	**1.64**%	1.88%	1.96%	2.11%	2.07%
Return on average shareholders equity	**13.15**%	15.12%	15.15%	16.62%	16.23%
Average shareholders equity as a percent of average total assets	**12.51**%	12.43%	12.97%	12.70%	12.74%
Dividends paid per share as a percent of basic net income per share	**47.8**%	43.1%	42.8%	40.3%	41.4%
SOURCE OF INCOME					
Commercial loans	**35.2**%	37.7%	39.4%	41.3%	38.5%
Construction loans	**6.3**	5.9	7.9	9.2	7.9
Residential real estate loans	**9.8**	10.7	10.6	9.8	10.2
Consumer loans	**9.6**	9.8	10.4	10.7	10.0
Federal funds sold, et al	**.5**	.7	.8	.2	.1
Securities	**15.8**	15.5	12.6	12.5	15.4
Total interest income	**77.2**	80.3	81.7	83.7	82.1
Investment and wealth management	**10.2**	9.4	8.7	9.1	9.5
Other income	**12.6**	10.3	9.6	7.2	8.4
Total income	**100.0**%	100.0%	100.0%	100.0%	100.0%
NET INTEREST INCOME (Tax-equivalent)					
Interest earned:					
Loans	**$ 477,276**	$ 473,120	$ 547,970	$ 552,548	$ 457,936
Federal funds sold, et al	**3,901**	5,213	6,190	1,857	781
Taxable securities	**117,615**	111,111	98,732	95,625	104,144
Tax-exempt securities	**4,543**	3,135	3,298	2,080	959

Total interest income	**603,335**	592,579	656,190	652,110	563,820
Interest paid:					
Savings deposits	**16,520**	25,536	39,993	48,362	48,442
Time deposits	**76,670**	97,033	159,710	134,086	109,555
Total interest-bearing deposits	**93,190**	122,569	199,703	182,448	157,997
Short-term borrowings	**5,604**	11,259	25,120	48,711	27,267
Long-term debt	**18,451**	10,754	6,702	5,951	4,818
Total interest expense	**117,245**	144,582	231,525	237,110	190,082
Net interest income	**$ 486,090**	$ 447,997	$ 424,665	$ 415,000	$ 373,738

Five-Year Selected Financial Data

Years Ended December 31, *(Dollars in thousands, except per share data)*	**2003**	2002	2001	2000	1999
NET INTEREST INCOME	**$ 479,330**	$ 441,804	$ 418,241	$ 409,385	$ 369,086
NET INCOME	**$ 196,814**	$ 190,238	$ 181,295	$ 175,230	$ 157,737
NET INCOME PER SHARE OF COMMON STOCK					
Basic	**$ 2.70**	$ 2.74	$ 2.57	$ 2.53	$ 2.27
Diluted	**$ 2.68**	$ 2.72	$ 2.55	$ 2.51	$ 2.25
TOTAL ASSETS	**$13,695,472**	$10,790,376	$9,928,786	$8,938,030	$7,895,024
LONG-TERM DEBT	**$ 647,722**	$ 287,214	$ 269,437	$ 92,547	$ 82,683
PROVISION FOR LOAN LOSSES	**$ 12,105**	$ 16,378	$ 13,434	$ 17,231	$ 12,056
PER SHARE CASH DIVIDENDS					
Common	**$ 1.29**	$ 1.18	$ 1.10	$ 1.02	$ .94
CASH DIVIDENDS DECLARED AND PAID					
On common stock	**$ 95,842**	$ 81,909	$ 77,597	$ 70,641	$ 65,113
YEAR-END LOAN DATA					
Commercial	**$ 2,577,021**	$ 2,300,956	$2,228,750	$2,215,039	$1,984,358
Commercial real estate	**2,738,832**	2,016,307	1,819,268	1,409,987	1,220,100
Construction	**1,064,021**	810,985	652,486	824,752	650,745
Residential real estate	**1,335,375**	1,066,694	1,060,519	1,086,674	878,900
Consumer	**1,067,360**	775,673	801,474	832,206	707,359
Home equity lines	**415,500**	239,232	189,867	168,944	147,560
Lease financing	**74,051**	102,180	153,882	155,692	123,108
Total loans	**9,272,160**	7,312,027	6,906,246	6,693,294	5,712,130
Less: Allowance for loan losses	**(155,337)**	(138,601)	(141,463)	(138,612)	(117,997)
Loans, net	**$ 9,116,823**	$ 7,173,426	$6,764,783	$6,554,682	$5,594,133

Five-Year Summary of Consolidated Income

Years Ended December 31, *(Dollars in thousands)*	**2003**	2002	2001	2000	1999
INTEREST INCOME					
Interest and fees on loans	**$472,379**	$468,298	$543,020	$547,942	$453,825
Interest and dividends on securities	**120,235**	112,860	100,538	96,687	104,556
Other interest income	**3,961**	5,228	6,208	1,866	787
Total interest income	**596,575**	586,386	649,766	646,495	559,168
INTEREST EXPENSE					
Interest on deposits	**93,190**	122,569	199,703	182,448	157,997
Interest on short-term borrowings	**5,604**	11,259	25,120	48,711	27,267
Interest on long-term debt	**18,451**	10,754	6,702	5,951	4,818
Total interest expense	**117,245**	144,582	231,525	237,110	190,082
NET INTEREST INCOME	**479,330**	441,804	418,241	409,385	369,086
Provision for loan losses	**12,105**	16,378	13,434	17,231	12,056
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**467,225**	425,426	404,807	392,154	357,030
NONINTEREST INCOME					
Investment and wealth management	**78,933**	68,435	69,331	69,850	65,036
Service charges on deposit accounts	**36,912**	31,454	28,085	24,346	23,043
Other income	**60,746**	43,861	48,074	31,345	33,912
Total noninterest income	**176,591**	143,750	145,490	125,541	121,991
NONINTEREST EXPENSE					
Salaries and employee benefits	**198,043**	165,371	152,887	140,391	134,665
Net occupancy and equipment	**52,366**	40,368	38,448	34,607	32,959
Amortization of goodwill			9,072	5,213	3,832
Other expenses	**87,038**	66,869	63,552	63,294	58,964
Total noninterest expenses	**337,447**	272,608	263,959	243,505	230,420

Income before income taxes	**306,369**	296,568	286,338	274,190	248,601
Applicable income taxes	**109,555**	106,330	105,043	98,960	90,864
NET INCOME	**$196,814**	$190,238	$181,295	$175,230	$157,737

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

I. EXECUTIVE OVERVIEW

Mercantile Bankshares Corporation (Bankshares) recorded its 28th consecutive year of increased net income in 2003. Net income for Bankshares was $196.8 million for the year ended December 31, 2003 compared to $190.2 million for the year 2002. However, diluted net income per common share for 2003 decreased by 1% to $2.68 compared to $2.72 for 2002 due largely to the higher adjusted weighted average shares outstanding for 2003. The most noteworthy factors affecting 2003 earnings were the acquisition of F&M Bancorp (F&M), the continuing repositioning of the Investment & Wealth Management (IWM) Division of the lead bank, Mercantile-Safe Deposit and Trust Company (MSD&T), and the downward pressure put on earnings by a lower net interest margin compared to the year earlier.

On August 12, 2003, Bankshares completed its acquisition of F&M Bancorp, a bank holding company headquartered in Frederick, Maryland. On the date of purchase, F&M 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). F&M is the second largest affiliate bank in the organization behind only MSD&T in total assets. The results of operations and balances for F&M are included in the consolidated financial statements from the merger date forward. Bankshares recorded $400.3 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. The weighted average amortization period for newly acquired core deposit intangible is nine years, and the client relationship and other identified intangibles range from three to fifteen years.

Investment and wealth management revenues benefited from rising equity market values and the inclusion of revenues from Boyd Watterson Asset Management LLC, an investment management firm and Peremel & Company, Inc., 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, assuming specific metrics are met, and become 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, 2003.

A generally sluggish economy, decreases in long-term interest rates, and Bankshares net asset sensitive position combined to drive the net interest margin 31 basis points lower for the year 2003 than for the year

2002. The net interest margin was 4.34% for 2003 compared to 4.65% for 2002. Approximately two-thirds, or 20 basis points, of the decline is attributable to the lower benefit derived from noninterest-bearing sources of funding, such as demand deposit accounts and shareholders equity. On a tax-equivalent basis, net interest income was reduced by nearly $30 million as a result of the margin compression. Management does not anticipate any significant change in the level of interest rates in 2004 and is looking for improved loan growth to help offset the continuing pressure on the net interest margin in the current low interest rate environment.

Although certain statistical performance measures declined slightly from the prior year, 2003 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 2003 ROA was 1.64%, compared to 1.88% for the year ended December 31, 2002. Bankshares 2003 ROE decreased to 13.15%, compared to the 15.12% reported for 2002. Average assets increased by 18% to $12.0 billion, average deposits increased by 18% to $9.0 billion and average loans increased by 14% to $8.1 billion for the year ended December 31, 2003, compared to the prior year. Approximately one-half of the respective increases in the year 2003 average balances are attributable to F&M. Bankshares also reports net 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). Net operating earnings totaled $200.3 million for the year 2003, an increase of 5% over the $190.9 million for 2002. Diluted net operating earnings per share for 2003 were $2.73 compared with $2.72 for last year. A reconciliation of GAAP basis net income to net operating earnings can be found in Footnote No. 22 of the financial statements.

Average shareholders equity to average assets remained strong at 12.51%, increasing slightly from 12.43% for 2002. In 2003, 5,500 shares were repurchased under Bankshares buyback plan in open market purchases. Bankshares was not an active acquirer during 2003 mainly due to the restrictions in place associated with our acquisition of F&M. The buyback plan retired 1,384,200 shares through open market purchases made during 2002.

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 is the basis for measuring the adequacy of capital for regulatory purposes. For the year 2003, return on average tangible assets was 1.71%, compared to 1.91% for the year 2002. The ratio of average tangible equity to average tangible assets for 2003 was 10.34% compared to 11.45% for 2002. 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) instead of issuing only shares to acquire F&M. For the reconciliation of GAAP to non-GAAP measures, see Footnote No. 22 of the financial statements.

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.

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 involve complex management judgments, uncertainties and/or estimates. Information regarding Bankshares other accounting policies is included in Footnote No. 1 of the financial statements.

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 information to assess the adequacy of the allowance for loan losses as well as information about the prevailing economic and business environment among other things. For a full discussion of Bankshares methodology for assessing the adequacy of the allowance for loan losses, see Allowance for Loan Losses below and Footnote 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) is 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. 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 Footnote No. 11 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 business combinations method of accounting, as well as from the purchase of other financial institutions branches (not the entire institution). For acquisitions under the purchase method, Bankshares is required to record assets acquired and liabilities assumed at their fair value, which is an estimate determined by the use of internal or other valuation techniques. See Footnote No. 19 of the financial statements for further information on the accounting for goodwill and other intangible assets.

II. ANALYSIS OF OPERATING RESULTS FOR 2003 TO 2002

Segment Reporting

Bankshares has 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 put in place at the time Bankshares was formed. At that time the organization consisted of: a lead bank, MSD&T, with two business segments Banking and IWM; and a Community Bank segment, which has been built through acquisitions and continued operation of independent charters. This latter segment consists of the group of 19 community banks (collectively, the Community Banks). Mortgage banking activities are not viewed as a separate business line and, accordingly, are included in the MSD&T Banking Division. A schedule disclosing the details of these operating segments can be found in Footnote No. 15 of the financial statements. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, the 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.

Community Banks

The addition of F&M 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 Community Bank segment as set forth below. Net income for the Community Banks for 2003 increased 16% to $139.1

million, compared to $119.6 million for 2002. Net interest income for the Community Banks increased 13% to $336.3 million for 2003 from $297.9 million for 2002. The growth in net interest income in 2003 was attributable to a 22% increase in average earning assets, which offset a 37 basis point decline in the net interest margin from 5.05% to 4.68%. F&M contributed over 50% to the growth in the Community Banks average earning assets.

Farmers & Mechanics Affiliate
Selected Balance Sheet Data

(Dollars in thousands)	At August 12, 2003	Proforma impact of opening balance on averages for the 12 months ended December 31, 2003
Investment securities available-for-sale	$ 637,962	$ 248,193
Loans:		
Commercial	176,689	68,739
Construction	114,982	44,733
Residential real estate	824,232	320,660
Consumer	248,625	96,725
Lease financing		
Total loans	1,364,528	530,857
Less: allowance for loan losses	(13,205)	(5,137)
Loans, net	1,351,323	525,720
Total assets	2,174,932	846,138
Deposits:		
Noninterest-bearing deposits	301,024	117,111
Interest-bearing deposits	1,395,758	543,007
Total deposits	1,696,782	660,118

As a reflection of the overall improvement in the Community Banks credit quality trends, the Community Banks recorded a reversal of $1.1 million in the provision for loan losses for 2003 as compared to a provision for loan losses of $4.6 million in 2002.

Average assets for the Community Banks increased 23% to $7.7 billion in 2003. Increases of 24% and 22% were recorded in the investment and loan portfolios, respectively. Average deposits for the Community Banks increased 22% to $6.2 billion in 2003. More than half of the growth in the Community Banks average balances was due to F&M.

At December 31, 2003, 63.9% of average total loans were held by the Community Banks, compared to 60.0% in 2002. Commercial loans, including commercial mortgages, accounted for 52.4% of the Community Banks average total loans, slightly higher than the 51.5% for 2002. These loans increased 24% from the 2002 average. Construction and consumer loans accounted for approximately the same portion of Community Bank loans in 2003 as in 2002, at 5.7% and 21.5%, respectively. Construction loans increased

35%, while consumer loans increased 22%, from 2002 levels. Residential real estate loans, which were 20.4% and 22.0% of average total loans for 2003 and 2002, respectively, increased 13%.

The Community Banks provided 68.4% of the average total deposit base of Bankshares, up from the 66.2% at 2002. The Community Banks generated 72.9% of average noninterest-bearing deposits in 2003, slightly higher than 72.0% in 2002. For 2003, 66.8% of average interest-bearing deposits were at the Community Banks, increasing from the 64.3% for 2002.

MSD&T Banking

MSD&T Banking recorded net income of $61.0 million in 2003, compared to $64.1 million in 2002. Net interest income for MSD&T decreased 3% in 2003 to $141.8 million from $146.2 million in 2002. Although average earning assets increased 4%, it was not enough to offset the decline in the net interest margin from 3.81% to 3.54%.

Due to continuing credit quality issues within MSD&T s commercial loan portfolio, MSD&T recorded a provision for loan losses of $13.2 million, an increase of 13% over the $11.7 million recorded in 2002. The allowance as a percent of loans was 1.96% in 2003 compared to 1.72% in 2002.

Average total assets for MSD&T increased 6% to $4.4 billion in 2003 from $4.1 billion in 2002. Average investments and loans increased only 2% and 3%, respectively, while federal funds sold and other assets accounted for the balance of the increase in average assets. Average deposits grew at a much higher rate of 13%.

At the end of 2003 commercial loans, at 71.4%, was the largest sector of MSD&T s average total loans, decreasing from 73.7% for 2002. MSD&T s construction loans comprised 21.8% of MSD&T s average total loans, up from 18.2% for 2002. Construction loans, which increased 23% over 2002, was the only MSD&T loan category to experience any growth during 2003. Residential real estate and consumer loans were 4.0% and 2.8% of the average total loan portfolio, respectively, which were relatively the same proportions to total loans as in 2002.

IWM

The net income for IWM was $5.1 million in 2003, versus $12.1 million in 2002. Pretax profit margins were 10.8% and 29.6% for 2003 and 2002, respectively.

At December 31, 2003, assets under administration by the IWM were $46.0 billion, an increase of $10.0 billion from the prior year. At their respective dates of acquisition Boyd Watterson Asset Management LLC and Peremel and Company, Inc. contributed approximately $3.6 billion and $0.6 billion, respectively, to the increase in assets under administration. Bankshares had investment management responsibility for $21.8 billion, up 41% from the prior year.

Revenues increased 15.7% to $78.6 million in 2003. Increased sales, the inclusion of Boyd Watterson Asset Management LLC and Peremel & Company, Inc. for 10 and 9 months of the year, respectively, and the increase in the equity markets beginning in April all contributed to the revenue increase and the growth in assets under management.

Expense growth associated with a full year of investments in people and new product capabilities exceeded the increase in revenues. Additionally, expenses for 2003 included $3.6 million of severance and $0.5 million paid to terminate a technology equipment lease, both of which were related to the ongoing repositioning of IWM s capabilities and its infrastructure. In 2002, severance expense for IWM totaled $1.7 million.

Substantial progress was made in repositioning the investment and wealth management business. New capabilities were added, including three registered hedge fund of funds, an expanded brokerage capability through Peremel & Company, Inc., an open architecture investment management platform, a 401(k) program and the introduction of the Mercantile Dow Jones U.S. Portfolio Funds. Distribution through the Community Banks grew with the introduction of an asset allocation platform.

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.

	2003			2002			2001		
(Dollars in thousands)	Average Balance**	Income*/ Expense	Yield*/ Rate	Average Balance**	Income*/ Expense	Yield*/ Rate	Average Balance**	Income*/ Expense	Yield*/ Rate
Earning assets									
Loans:									
Commercial	**$ 4,795,334**	**$276,788**	**5.77%**	$ 4,283,322	$278,995	6.51%	$3,978,335	$317,769	7.99%
Construction	**929,939**	**50,324**	**5.41**	733,237	44,667	6.09	795,931	63,359	7.96
Residential real estate	**1,171,194**	**75,651**	**6.46**	1,072,297	78,233	7.30	1,059,798	84,102	7.94
Consumer	**1,192,515**	**74,513**	**6.25**	999,988	71,225	7.12	998,792	82,740	8.28
Total loans	**8,088,982**	**477,276**	**5.90**	7,088,844	473,120	6.67	6,832,856	547,970	8.02
Federal funds sold, et al	**250,462**	**3,901**	**1.56**	178,624	5,213	2.92	141,245	6,190	4.38
Securities:									
Taxable securities U.S. Treasury securities	**1,021,513**	**41,233**	**4.04**	1,478,387	67,531	4.57	1,366,245	73,653	5.39
U.S. Agency securities	**709,519**	**32,399**	**4.57**	610,617	30,072	4.92	339,298	19,812	5.84
Mortgage-backed securities	**927,235**	**36,135**	**3.90**	216,391	12,096	5.59	48,203	3,599	7.47
Other stocks and bonds	**114,924**	**7,788**	**6.78**	23,220	1,397	6.02	21,934	1,650	7.52
Tax-exempt securities									
States and political subdivisions	**69,888**	**4,543**	**6.50**	38,799	3,135	8.08	40,359	3,298	8.17
Total securities	**2,843,079**	**122,098**	**4.29**	2,367,414	114,231	4.83	1,816,039	102,012	5.62
Interest-bearing deposits in other banks	**9,085**	**60**	**.66**	358	15	4.12	365	18	4.98
Total earning assets	**11,191,608**	**603,335**	**5.39**	9,635,240	592,579	6.15	8,790,505	656,190	7.46

Cash and due from banks	**266,173**			227,034			215,852		
Bank premises and equipment, net	**118,071**			101,660			102,993		
Other assets	**543,341**			300,422			260,333		
Less: allowance for loan losses	**(147,612)**			(140,899)			(142,481)		
Total assets	**$11,971,581**			$10,123,457			$9,227,202		
Interest-bearing liabilities									
Deposits:									
Savings	**$ 1,168,074**	**4,702**	**.40**	$ 966,283	8,405	.87	$ 853,911	12,899	1.51
Checking plus interest accounts	**1,071,877**	**2,061**	**.19**	873,497	2,908	.33	771,186	5,255	.68
Money market	**1,357,234**	**9,757**	**.72**	1,096,417	14,223	1.30	846,577	21,839	2.58
Time deposits $100,000 and over	**1,272,327**	**29,464**	**2.32**	1,080,347	34,671	3.21	1,145,569	62,350	5.44
Other time deposits	**1,852,622**	**47,206**	**2.55**	1,759,160	62,362	3.54	1,812,589	97,360	5.37
Total interest-bearing deposits	**6,722,134**	**93,190**	**1.39**	5,775,704	122,569	2.12	5,429,832	199,703	3.68
Short-term borrowings	**851,348**	**5,604**	**.66**	845,938	11,259	1.33	744,907	25,120	3.37
Long-term debt	**517,386**	**18,451**	**3.57**	279,471	10,754	3.85	117,823	6,702	5.69
Total interest-bearing funds	**8,090,868**	**117,245**	**1.45**	6,901,113	144,582	2.10	6,292,562	231,525	3.68
Noninterest-bearing deposits	**2,269,720**			1,856,706			1,618,838		
Other liabilities and accrued expenses	**113,848**			107,671			118,744		
Total liabilities	**10,474,436**			8,865,490			8,030,144		
Shareholders equity	**1,497,145**			1,257,967			1,197,058		
Total liabilities & shareholders equity	**$11,971,581**			$10,123,457			$9,227,202		
Net interest rate spread		**$486,090**	**3.94%**		$447,997	4.05%		$424,665	3.78%

Effect of noninterest-bearing funds	**.40**	.60	1.05
Net interest margin on earning assets	**4.34%**	4.65%	4.83%
Tax-equivalent adjustment included in:			
Loan income	**$ 4,897**	$ 4,822	$ 4,950
Investment securities income	**1,863**	1,371	1,474
Total	**$ 6,760**	$ 6,193	$ 6,424

* Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35%.

** Average investment securities are reported at amortized cost and exclude pretax unrealized gains (losses) on securities available-for-sale. Nonaccrual loans are included in average loans.

Net Interest Income

Net interest income represents the largest source of Bankshares revenue. It is affected by both changes in the level of interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities. Interest rate risk represents one of the more significant risks facing financial institutions like Bankshares. See additional discussion under the caption Interest Rate Risk, below. It is measured in terms of the effect changes in market interest rates have on net interest income. Bankshares is asset sensitive, with assets repricing more quickly than liabilities in response to changes in interest rates. In a falling rate environment, Bankshares net interest margin (net interest income expressed as a percent of average earning assets) compresses, causing net interest income to slow. Net interest income, on a fully tax-equivalent basis, was $486.1 million for 2003. This represents an increase of 9%, or $38.1 million, over the prior year s $448.0 million. In 2002, fully tax-equivalent net interest income increased by $23.3 million, or 6%, over 2001. As previously noted, net interest income is affected by changes in the volume of earning assets and the net interest margin earned thereon. The Rate/Volume Analysis table below presents further details supporting this discussion.

Average earning assets increased by $1.6 billion, or 16%, in 2003, with approximately 50% of this increase attributable to the F&M acquisition. Average total loans grew $1.0 billion, or 14%, during 2003. As with earning assets, approximately 50% of this growth relates to the F&M acquisition. Despite the sluggish economy, organic loan growth was fairly consistent throughout the year. While average total loans grew by $256.0 million, or 4%, during 2002, substantially all of the growth occurred during the first half of the year. Average securities, the other major component of earning assets, increased by $475.7 million, or 20%, in 2003 compared to an increase of $551.4 million, or 30%, in the prior year. The F&M acquisition accounted for slightly less than 50% of the increase in 2003. The slowing in the growth of the investment portfolio is attributable to the improved loan growth rate and a slowing in the deposit growth rate, especially in the fourth quarter of 2003. See III. Analysis of Financial Condition below for a more in-depth discussion of balance sheet trends. The overall growth in average earning assets added $67.9 million to net interest income in 2003.

Offsetting the increase in net interest income from the growth in average earning assets was a 31 basis point decline in the net interest margin from 4.65% in 2002 to 4.34% in 2003. The decline in the net interest margin reduced net interest income by $29.9 million. The net interest margin declined for the third straight year. The net interest spread also declined by 11 basis points to 3.94% in 2003 from 4.05% in 2002. The net interest spread is the difference between the yield earned on total earning assets and the rate paid on total interest-bearing liabilities.

In response to the slowing economy, the Board of Governors of the Federal Reserve System (the Federal Reserve Board) began taking action in 2001 to reduce short-term interest rates. They reduced short-term rates by 475 basis points in 2001, followed by 50 basis points in 2002 and 25 basis points in 2003. The net interest margin declined by 43 basis points in 2001, primarily as a result of the unprecedented drop in the level of short-term interest rates. Since 2001, the margin has continued to decline, not because of the additional short-term rate reductions, but due to a decline in intermediate and long-term interest rates. The impact of the decline in these rates is reflected in the benefit Bankshares derives from its noninterest-bearing sources of funding earning assets. Such benefit declined by 45 basis points in 2002 and 20 basis points in 2003, a combined decline of 65 basis points over the two-year period. Approximately 28% of the funding of average earning assets is derived from noninterest-bearing sources.

The 11 basis point decline in the spread during 2003 is attributable to the difficulty of further reducing the rate paid on managed-rate deposits (savings, checking plus interest and money market accounts) and remaining competitive in the marketplace. The average yield on earning assets declined 76 basis points to 5.39% in 2003. In comparison, the average rate paid on interest-bearing funds declined only 65 basis points to 1.45% in 2003, from 2.10% in 2002.

MSD&T s net interest margin decreased 27 basis points, from 3.81% in 2002 to 3.54% in 2003. The Community Banks net interest margin decreased 37 basis points, from 5.05% in 2002 to 4.68% in 2003. Over the two-year period ended December 31, 2003, MSD&T s net interest margin declined 50 basis points compared to a decline of 53 basis points for the Community Banks. The Community Banks account for most of Bankshares residential real estate and consumer loan portfolios. These portfolios were most affected by the refinancing triggered by the drop in intermediate and long-term rates. As a result, the net interest margin contracted to a greater extent at the Community Banks than at MSD&T.

Understanding the trend of the net interest margin during 2003 is important when assessing the outlook for the net interest margin in the year ahead. The net interest margin was 4.57% for the first quarter of 2003, up 2 basis points from the fourth quarter of 2002. During the second quarter of 2003, the margin dropped 19 basis points, followed by an additional 19 basis point decline in the third quarter. During this six-month period, intermediate and long-term interest rates declined, triggering a surge in consumer and mortgage loan refinancing. During the fourth quarter of 2003, intermediate and long-term rates increased from their low levels, slowing the pace of refinancing and improving yields on new consumer and mortgage loans. Bankshares net interest margin improved 9 basis points to 4.28% for the fourth quarter of 2003. Looking forward to 2004, management does not anticipate an increase in short-term interest rates or overall interest rates from where they were at the close of 2003. Normally, this stable scenario would result in a downward movement in the net interest margin as fixed-rate loans and investments mature and are replaced by loans and investments at lower current yields. However, with some signs of an improving economy beginning to emerge, management anticipates the net interest margin will remain stable, as improving loan growth should result in earning assets more heavily weighted toward higher yielding loans compared to investment securities. For additional information regarding interest rate sensitivity, see the discussion in the Interest Rate Risk section below.

RATE/VOLUME ANALYSIS

A rate/volume analysis, which demonstrates changes in tax-equivalent interest income and expense for significant assets and liabilities, appears below. The calculation of rate and volume variances is based on a procedure established for banks by the Securities and Exchange Commission.

	Year Ended December 31,					
	2003 vs. 2002 Due to variances in			2002 vs. 2001 Due to variances in		
(Dollars in thousands)	Total	Rates	Volumes(4)	Total	Rates	Volumes(4)
Interest earned on:						
Loans:						
Commercial (1)	$ (2,207)	$(35,557)	$33,350	$(38,774)	$ (63,135)	$24,361
Construction (2)	5,657	(6,326)	11,983	(18,692)	(13,701)	(4,991)
Residential real estate	(2,582)	(9,797)	7,215	(5,869)	(6,861)	992
Consumer	3,288	(10,425)	13,713	(11,515)	(11,614)	99
Taxable securities (3)	6,459	(14,751)	21,210	12,382	(18,357)	30,739
Tax-exempt securities (3)	1,408	(1,104)	2,512	(163)	(36)	(127)
Federal funds sold, et al	(1,312)	(3,409)	2,097	(977)	(2,615)	1,638
Interest-bearing deposits in other banks	45	(321)	366	(3)	(3)	
Total interest income	10,756	(81,690)	92,446	(63,611)	(116,322)	52,711
Interest paid on:						
Savings deposits	(3,703)	(5,458)	1,755	(4,494)	(6,191)	1,697
Checking plus interest deposits	(847)	(1,507)	660	(2,347)	(3,044)	697
Money market accounts	(4,466)	(7,849)	3,383	(7,616)	(14,061)	6,445
Certificates of deposit $100,000 and over	(5,207)	(11,368)	6,161	(27,679)	(24,129)	(3,550)
Other time deposits	(15,156)	(18,469)	3,313	(34,998)	(32,128)	(2,870)
Short-term borrowings	(5,655)	(5,727)	72	(13,861)	(17,268)	3,407
Long-term debt	7,697	(1,458)	9,155	4,052	(5,143)	9,195
Total interest expense	(27,337)	(51,836)	24,499	(86,943)	(101,964)	15,021
Net interest earned	$ 38,093	$(29,854)	$67,947	$ 23,332	$ (14,358)	$37,690

(1) Tax-equivalent adjustments of $3.6 million for 2003, $3.6 million for 2002 and $4.1 million for 2001 are included in the calculation of commercial loan rate variances.

(2) Tax-equivalent adjustments of $1.3 million for 2003, $1.2 million for 2002 and $867 thousand for 2001 are included in the calculation of construction loan rate variances.

(3) Tax-equivalent adjustments of $1.9 million for 2003, $1.4 million for 2002 and $1.5 million for 2001 are included in the calculation of investment securities rate variances.

(4) Changes attributable to mix (rate and volume) are included in volume variance.

Interest Income

Fully tax-equivalent interest income amounted to $603.3 million in 2003, an increase of $10.7 million, or 2%, from $592.6 million in 2002. This compares favorably to the $63.6 million, or 10% decrease in 2002 from 2001. The slight increase in 2003 was due to a decline in market interest rates, resulting in an $81.7 million reduction in interest income, offset by $92.4 million in additional interest income generated by the growth in earning assets primarily due to the addition of F&M. During 2002, the $116.3 million reduction in interest income resulted from the lower yield on earning assets and was only partially offset by the $52.7 million increase derived from the growth in earning assets.

At year-end 2003, the prime rate was 4.00%, compared to 4.25% and 4.75% at year-end 2002 and 2001, respectively. The average prime rate was 4.12% for 2003, compared to 4.72% for 2002, a decline of 60 basis points. The yield on average total loans in 2003 was 5.90%, a 77 basis point decline from 6.67% in 2002. The commercial and construction loan portfolios are the most sensitive to changes in short-term interest rates, while the residential real estate and consumer loan portfolios are mostly affected by long-term rates. The yield on the consumer loan portfolio declined 87 basis points and the residential real estate portfolio declined by 84 basis points. The commercial and construction loan portfolios declined by 74 and 68 basis points, respectively. These declines reflected the Federal Reserve Board s 50 basis point reduction in short-term rates during the fourth quarter of 2002 and 25 basis point reduction at the end of the second quarter of 2003.

The yield on investment securities, at 4.29% in 2003, declined 54 basis points from 4.83% in 2002. The yield on the portfolio decreased 79 basis points in 2002 from 5.62% in 2001. More than offsetting the negative impact on interest income from reinvesting at lower yields has been the increasing size and changing mix of the portfolio. During 2003 Bankshares followed a strategy begun in 2002 to shift from U.S. Treasury to higher yielding U.S. agency securities and mortgage-backed securities. This has resulted in a mix of 27%, 25% and 41%, respectively, at December 31, 2003. The other 7% of the investment securities was comprised of 3% municipals and 4% other investments at year end.

Interest Expense

Total interest expense in 2003 was $117.2 million, a decrease of $27.4 million from $144.6 million in 2002. The decrease in interest expense for 2003 was attributable to a decrease in the rate paid on total interest-bearing funds of 65 basis points, which was partially offset by a 17% growth in average balances. Total interest expense in 2002 was $86.9 million less than the $231.5 million reported in 2001. With the combination of interest rates at record low levels and slowing deposit inflows, management does not anticipate that it will be able to significantly reduce the rate paid on managed-rate deposits (savings, checking plus interest and money market accounts). See management s discussion under Interest Rate Risk below for further information regarding Bankshares exposure to changes in interest rates.

The rate paid on average total interest-bearing deposits was 1.39% in 2003, a decline of 73 basis points from 2.12% for the prior year. The rate paid on savings, checking plus interest and money market accounts declined 47 basis points, 14 basis points and 58 basis points, respectively. Certificates of deposit-$100,000 and over declined 89 basis points, while the rate paid on other time deposits decreased 99 basis points in 2003.

The most interest rate sensitive source of funds is short-term borrowings. This category is comprised of federal funds purchased, securities sold under agreement to repurchase and commercial paper. The duration of these funds is very short, with most repricing daily. Reflecting the rate environment, the rate paid on short-term borrowings declined 67 basis points to 0.66% in 2003, after having decreased by 204 basis points in 2002 to 1.33%. The rate paid on long-term debt declined 28 basis points in 2003, following a decline of 184 basis points in the prior year. The decline is primarily related to the $200 million of 10-year debt issued by MSD&T in the fourth quarter of 2001. These notes, which were issued at a fixed rate of 5.70%, were converted to a floating rate through an interest rate swap. The notes reprice quarterly and carried an effective cost of 2.18% during 2003. Additionally, Bankshares issued $300 million of subordinated debt in April 2003. The notes were issued at a fixed rate of 4.65%. Subsequently, $150 million of this debt was converted to a floating rate through interest rate swaps. The effect of the swap lowered the cost on the $300 million debt to 3.96% during 2003.

NONINTEREST INCOME

A schedule of noninterest income over the past three years is presented below:

	Year Ended December 31,			% Change	
(Dollars in thousands)	**2003**	2002	2001	2003/2002	2002/2001
Investment and wealth management	**$ 78,933**	$ 68,435	$ 69,331	15.3%	(1.3)%
Service charges on deposit accounts	**36,912**	31,454	28,085	17.4	12.0
Mortgage banking related fees					
Commercial	**6,645**	5,609	7,319	18.5	(23.4)
Residential	**4,466**	4,336	5,263	3.0	(17.6)
Total mortgage banking related fees	**11,111**	9,945	12,582	11.7	(21.0)
Investment securities gains	**7,137**	846	4,248	743.6	(80.1)
Other income					
Electronic banking fees	**16,814**	15,076	13,956	11.5	8.0
Charges and fees on loans	**9,549**	8,440	6,372	13.1	32.5
Insurance	**4,656**	1,141	1,327	308.1	(14.0)
Bank-owned life insurance	**2,003**	869		130.5	100.0
All other fees	**9,476**	7,544	9,589	25.6	(21.3)
Total other income	**42,498**	33,070	31,244	28.5	5.8
Total	**$176,591**	$143,750	$145,490	22.8%	(1.2)%

Noninterest Income

Noninterest income for 2003 increased by $32.8 million, or 23%, to $176.6 million compared to $143.8 million for 2002. The table above shows the major components of noninterest income. Investment and Wealth Management revenue represents the largest source of noninterest income at 45%. Improvement in IWM revenue came principally from the inclusion of Boyd Watterson Asset Management LLC and Peremel & Company, Inc., which were acquired on March 1, 2003 and April 1, 2003, respectively. Together, these acquisitions added $8.2 million in revenues. The improved performance in equity markets that began in the second quarter of 2003 had a positive impact on IWM revenues, mostly in the second half of the year. Approximately 35% of IWM s managed assets is invested in equities. Between December 31, 2002 and December 31, 2003, major equity indices rose sharply. The S&P 500 index was up 26%, the Dow Jones Industrial Average was up 25% and the Nasdaq was up 50%. Higher revenues also reflected increased new sales across both mutual funds and separately managed accounts. For 2004, revenues will benefit from a full year of Boyd Watterson and Peremel. Additional growth will depend on continued new sales and increased distribution, equity and bond market conditions and further acquisitions, if any. See the discussion under Segment Reporting above for additional information relating to IWM.

Service charges on deposit accounts increased in line with the growth in core consumer and commercial deposit balances. This growth is a result not only of the F&M acquisition, but also of significant growth in Bankshares deposits excluding F&M. The $5.5 million, or 17%, growth in service charge income is almost equally divided between the F&M acquisition and core deposit growth. Additionally, a reduction in waivers of nonsufficient funds and overdraft charges increased these fees $2.9 million, or 20%. Commercial account analysis fees increased $600 thousand, or 12%, primarily due to reduced earning credits on these accounts as a result of lower interest rates during 2003.

Mortgage banking fees increased by $1.2 million to $11.1 million in 2003. Bankshares mortgage banking revenue is comprised of loan origination fees, which is the largest category at 55% of total mortgage banking fees; servicing fees; and net gain on the sales of mortgage loans. Mercantile Mortgage Corporation s commercial loan origination and servicing fees increased by a combined $1.0 million due to the activities of its subsidiary, Columbia National Real Estate Financing LLC. Commercial mortgages are sold in the secondary market with rights to servicing retained. Residential mortgage banking fees increased by $0.2 million due to activities conducted by F&M and by Mercantile Mortgage Corporation through its joint venture with Wells Fargo Ventures LLC (WFV). Mercantile Mortgage Corporation owns a 49.9% stake in Mercantile Mortgage LLC, which has originated retail mortgages since April 2002. Bankshares reports its share of the net profits from the joint venture as mortgage banking fees. The financial risk for Bankshares is the initial capital contribution to the venture, which is minimal. As the primary beneficiary and managing partner, WFV is responsible for consolidating the joint venture in its financial statements. Either party may terminate the joint venture with 60 days notice. Residential mortgages are sold in the secondary market with rights to servicing released. During 2004, F&M s residential mortgage business will be integrated into the joint venture. Historically, MSD&T has utilized the joint venture to underwrite and close residential mortgages on its behalf. As a result of the F&M integration, the joint venture will be offering this service to several of the Community Banks.

Investment securities gains mostly represent sales of equity securities, with the balance related to the continued restructuring of the investment securities bond portfolios held in available-for-sale portfolios. These gains were generated as part of a repositioning of the balance sheet for interest rate changes that adjust portfolio yields and duration.

Other income includes several categories. Electronic banking fees consist of merchant card processing fees, foreign ATM fees and debit card fees. These fees increased to $16.8 million, up 12% from 2002. Charges and fees on loans consist of letters of credit fees, late fees and other assessed loan fees. Sixty percent of the increase in this category is attributable to F&M. Letters of credit fees decreased $1.1 million. This decrease was more than offset by an 18% increase in late fees of $490 thousand and a 60% increase, or $1.7 million in other loan fees. Insurance revenues are derived from fee income related to the sale and servicing of insurance products. The $3.5 million increase is due primarily to F&M, which operates two wholly owned subsidiaries, Keller Stonebraker Insurance, Inc. and Potomac Basin Group Associates, Inc. These insurance agencies provide a full line of consumer and commercial products. Consumer products include annuities, homeowners, automobile, life and personal umbrella insurance products. Commercial products include property and casualty packages, workers compensation, bonds, professional liability and 401(k) and other benefit plans. Bankshares invested $50.0 million in bank-owned life insurance (BOLI) during the third quarter of 2002. The Company invested in BOLI to provide funding for future employee benefit costs. Executive and middle management employees are insured under the plan. Income, which reflects changes in the cash surrender value, was $1.1 million higher than in 2002 due to a full year s earnings for 2003 compared to less than one-half year s earnings in 2002. BOLI investment income is exempt from federal and state income tax, and related costs of the insurance are not tax deductible. The BOLI is invested primarily in high grade corporate and government bonds and mortgage-backed securities. All other income consists of revenues from various sources, such as safe deposit box rent, travelers checks, money orders and bill collection fees.

NONINTEREST EXPENSES

A schedule of noninterest expenses over the past three years is presented below:

	Year Ended December 31,			% Change	
(Dollars in thousands)	**2003**	2002	2001	2003/2002	2002/2001
Salaries	**$160,326**	$133,200	$123,712	20.4%	7.7%
Employee benefits	**37,717**	32,171	29,175	17.2	10.3
Net occupancy expense of bank premises	**20,756**	15,904	14,440	30.5	10.1
Furniture and equipment expense	**31,610**	24,464	24,008	29.2	1.9
Communication and supplies	**15,188**	13,375	13,086	13.6	2.2
Other expenses					
Professional services	**19,500**	11,221	9,479	73.8	18.4
Advertising and promotional expense	**9,155**	6,872	6,818	33.2	.8
Electronic banking expense	**7,657**	6,937	7,000	10.4	(.9)
Amortization of intangible assets	**4,943**	1,972	2,082	150.7	(5.3)
All other expenses	**30,595**	26,492	25,087	15.5	5.6
Total other expenses	**71,850**	53,494	50,466	34.3	6.0
Noninterest expenses before amortization of good will	**337,447**	272,608	254,887	23.8	7.0
Amortization of goodwill			9,072		(100.0)
Total	**$337,447**	$272,608	$263,959	23.8%	3.3%

Noninterest Expenses

Noninterest expenses increased $64.8 million, or 24%, from the 2002 level. The table above shows the major components of noninterest expenses. The principal reason for the year-over-year increase in each noninterest expense category was the inclusion of F&M, Boyd Watterson Asset Management LLC and Peremel & Company, Inc. In 2003, $8.0 million was recorded in pretax merger-related expenses related to the F&M acquisition. There were no merger-related expenses recognized in 2002. For further information regarding the various categories that merger-related expenses affected, see Footnote No. 2 of the financial statements.

Controlling costs and maintaining operational efficiencies remain primary objectives for Bankshares. A key measure that is closely monitored is Bankshares overall efficiency ratio. It is computed by dividing noninterest expenses by the sum of net interest income on a tax-equivalent basis and noninterest income. Bankshares efficiency ratio was 50.9% compared to 46.1% for the years ended December 31, 2003 and 2002, respectively. About half of the increase in the efficiency ratio for 2003 compared to 2002 was due to the significant investments in IWM during 2003. The other half of the increase was due to the decline in Bankshares net interest margin for 2003. On a non-GAAP basis, the operating efficiency ratio excludes amortization expense for intangibles, nonoperating income and expenses, such as securities gains and losses and merger-related expenses. Bankshares operating efficiency ratio was 49.5%, compared to 45.8%

for the years ended De