MERCANTILE BANKSHARES CORP
Form 10-Q
November 10, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2003

OR

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

For the transition period from to

Commission file number 0-5127

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.)

2 Hopkins Plaza

Baltimore, Maryland 21201
(Address of principal executive offices) (Zip Code)

(410) 237-5900

(Registrant s telephone number, including area code)

NONE

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practical date. As of October 21, 2003, registrant had outstanding 79,617,141 shares of Common Stock.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

MERCANTILE BANKSHARES CORPORATION

CONSOLIDATED BALANCE SHEET

(Dollars in thousands, except per share data)	September 30, 2003	December 31, 2002	September 30, 2002
ASSETS			
Cash and due from banks	**$ 375,627**	$ 281,130	$ 333,824
Interest-bearing deposits in other banks	**50,518**	358	358
Federal funds sold	**350,825**	264,293	272,134
Securities purchased under resale agreements			
Total cash and cash equivalents	**776,970**	545,781	606,316
Investment securities available-for-sale (Note 4)	**3,128,594**	2,511,192	2,411,941
Investment securities held-to-maturity (Note 4)	**56,057**	53,391	52,454
Loans held-for-sale	**26,288**		94
Loans:			
Commercial	**5,145,346**	4,317,263	4,213,108
Construction	**1,043,522**	810,985	790,318
Residential real estate	**1,299,665**	1,066,694	1,067,868
Consumer	**1,445,004**	1,014,905	1,009,040
Lease financing	**81,545**	102,180	120,456
Total loans	**9,015,082**	7,312,027	7,200,790
Less: allowance for loan losses	**(155,754)**	(138,601)	(136,587)
Loans, net	**8,859,328**	7,173,426	7,064,203
Bank premises and equipment, less accumulated depreciation of $161,720 (2003), $119,666 (December 2002) and $116,687 (September 2002)	**137,100**	102,428	102,223
Other real estate owned, net	**397**	132	123
Goodwill, net	**510,406**	102,705	102,705
Other intangible assets, net (Note 7)	**57,359**	7,530	7,999
Other assets	**323,649**	293,791	234,816
Total assets	**$ 13,876,148**	$ 10,790,376	$ 10,582,874
LIABILITIES			
Deposits:			
Noninterest-bearing deposits	**$ 2,698,277**	$ 2,086,745	$ 2,040,521
Interest-bearing deposits	**7,597,565**	6,174,195	6,004,976
Total deposits	**10,295,842**	8,260,940	8,045,497
Short-term borrowings	**958,506**	823,385	811,840
Accrued expenses and other liabilities	**140,913**	94,479	105,803
Long-term debt	**658,565**	287,214	289,313

Total liabilities		**12,053,826**		9,466,018		9,252,453
SHAREHOLDERS EQUITY						
Preferred stock, no par value; authorized 2,000,000 shares; issued and outstanding - None						
Common stock, $2 par value; authorized 130,000,000 shares; issued shares - 79,602,236 (2003), 68,836,092 (December 2002) and 69,612,217 (September 2002); restricted shares - 123,442 (2003), 76,250 (December 2002) and 67,215 (September 2002)		**159,204**		137,672		139,224
Capital surplus		**544,818**		120,577		150,592
Retained earnings		**1,085,979**		1,010,248		982,408
Accumulated other comprehensive income (loss)		**32,321**		55,861		58,197
Total shareholders equity		**1,822,322**		1,324,358		1,330,421
Total liabilities and shareholders equity	**$**	**13,876,148**	$	10,790,376	$	10,582,874

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENT OF CONSOLIDATED INCOME

(Dollars in thousands, except per share data)	For the 9 Months Ended September 30, 2003	For the 9 Months Ended September 30, 2002	For the 3 Months Ended September 30, 2003	For the 3 Months Ended September 30, 2002
INTEREST INCOME				
Interest and fees on loans	**$ 343,091**	$ 352,220	**$ 120,137**	$ 118,398
Interest and dividends on investment securities:				
Taxable interest income	**81,107**	82,478	**27,285**	27,487
Tax-exempt interest income	**1,747**	1,429	**783**	470
Dividends	**640**	800	**212**	258
Other investment income	**4,390**	156	**1,508**	52
Total interest and dividends on investment securities	**87,884**	84,863	**29,788**	28,267
Other interest income	**3,331**	4,039	**1,291**	1,372
Total interest income	**434,306**	441,122	**151,216**	148,037
INTEREST EXPENSE				
Interest on deposits	**70,892**	94,268	**22,313**	30,659
Interest on short-term borrowings	**4,317**	9,074	**1,303**	2,834
Interest on long-term debt	**13,016**	8,253	**5,368**	2,630
Total interest expense	**88,225**	111,595	**28,984**	36,123
NET INTEREST INCOME	**346,081**	329,527	**122,232**	111,914
Provision for loan losses	**9,072**	11,443	**3,005**	3,244
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**337,009**	318,084	**119,227**	108,670
NONINTEREST INCOME				
Investment and wealth management	**57,450**	51,521	**20,577**	17,166
Service charges on deposit accounts	**26,072**	23,161	**9,701**	7,972
Mortgage banking related fees	**8,298**	7,395	**3,403**	2,306
Investment securities gains and (losses)	**7,015**	846	**(336)**	(203)
Other income	**30,358**	24,107	**12,558**	8,145
Total noninterest income	**129,193**	107,030	**45,903**	35,386
NONINTEREST EXPENSES				
Salaries	**114,602**	98,825	**43,870**	32,809
Employee benefits	**28,891**	25,076	**10,144**	8,476
Net occupancy expense of bank premises	**13,451**	12,214	**5,136**	4,245
Furniture and equipment expenses	**21,974**	18,062	**8,432**	6,003
Communications and supplies	**10,506**	10,014	**3,889**	3,351
Other expenses	**48,595**	38,567	**19,718**	13,753
Total noninterest expenses	**238,019**	202,758	**91,189**	68,637
Income before income taxes	**228,183**	222,356	**73,941**	75,419
Applicable income taxes	**82,014**	80,621	**26,768**	26,804
NET INCOME	**$ 146,169**	$ 141,735	**$ 47,173**	$ 48,615
NET INCOME PER SHARE OF COMMON STOCK (Note 3):				

Basic	**$**	**2.07**	$	2.03	**$**	**.64**	$	.70
Diluted	**$**	**2.05**	$	2.02	**$**	**.63**	$	.69
DIVIDENDS PAID PER COMMON SHARE	**$**	**.96**	$	.88	**$**	**.33**	$	.30

See notes to consolidated financial statements

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MERCANTILE BANKSHARES CORPORATION

STATEMENT OF CONSOLIDATED CASH FLOW

Increase (Decrease) in Cash and Cash Equivalents	**For The 9 Months Ended September 30,**	
(Dollars in thousands)	**2003**	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 146,169**	$ 141,735
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**9,072**	11,443
Depreciation and amortization	**10,028**	9,679
Amortization of other intangible assets	**3,097**	1,561
Investment securities gains	**(7,015)**	(846)
Write-downs of investments in private equity funds	**78**	2,494
Write-downs of other real estate owned	**7**	2
Gains on sales of other real estate owned	**(350)**	(51)
Gains on sales of buildings	**(228)**	(456)
Net (increase) decrease in assets:		
Interest receivable	**2,727**	(2,170)
Other receivables	**(10,743)**	(2,999)
Bank owned life insurance	**(1,337)**	(868)
Other assets	**(16,485)**	(15,529)
Loans held-for-sale	**19,733**	137,856
Net increase (decrease) in liabilities:		
Interest payable	**8,422**	(3,520)
Accrued expenses	**(18,974)**	(5,262)
Taxes payable	**(12,496)**	(588)
Net cash provided by operating activities	**131,705**	272,481
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities of investment securities held-to-maturity	**8,406**	2,667
Proceeds from maturities of investment securities available-for-sale	**772,637**	419,357
Proceeds from sales of investment securities available-for-sale	**558,481**	79,253
Purchases of investment securities held-to-maturity	**(2,486)**	(2,852)
Purchases of investment securities available-for-sale	**(1,274,441)**	(570,227)
Net increase in customer loans	**(403,404)**	(310,983)
Proceeds from sales of other real estate owned	**748**	227
Capital expenditures	**(9,311)**	(11,126)
Proceeds from sales of buildings	**602**	975
Purchase of bank owned life insurance		(50,000)
Business acquisitions	**(152,654)**	
Cash from acquired bank	**70,450**	
Other investing activity	**(3,515)**	(11,654)
Net cash used in investing activities	**(434,487)**	(454,363)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in noninterest-bearing deposits	**315,196**	156,643

Net increase in checking plus interest and savings accounts		**110,249**		398,525
Net (decrease) increase in certificates of deposit		**(82,637)**		42,957
Net decrease in short-term borrowings		**(37,889)**		(41,438)
Proceeds from issuance of long-term debt		**300,000**		
Repayment of long-term debt		**(8,400)**		(8,300)
Proceeds from issuance of shares		**7,232**		6,566
Repurchase of common shares		**(212)**		(19,754)
Dividends paid		**(69,568)**		(61,348)
Net cash provided by financing activities		**533,971**		473,851
Net increase in cash and cash equivalents		**231,189**		291,969
Cash and cash equivalents at beginning of period		**545,781**		314,347
Cash and cash equivalents at end of period	**$**	**776,970**	$	606,316

See notes to consolidated financial statements

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MERCANTILE BANKSHARES CORPORATION

STATEMENT OF CHANGES IN CONSOLIDATED SHAREHOLDERS EQUITY

FOR THE 9 MONTHS ENDED SEPTEMBER 30, 2003 AND 2002

(Dollars in thousands, except per share data)	Total	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
BALANCE, DECEMBER 31, 2001	$ 1,230,206	$ 139,551	$ 159,947	$ 904,479	$ 26,229
Net income	141,735			141,735	
Unrealized gains(losses) on securities available-for-sale, net of reclassification adjustment, net of taxes	31,968				31,968
Comprehensive income	173,703				
Cash dividends paid:					
Common stock ($.88 per share)	(61,348)			(61,348)	
Issuance of 80,889 shares for dividend reinvestment and stock purchase plan	2,889	162	2,727		
Issuance of 16,981 shares for employee stock purchase dividend reinvestment plan	684	34	650		
Issuance of 175,922 shares for employee stock option plan	2,993	352	2,641		
Issuance of 67,215 shares for restricted stock awards	3,019	134	2,885		
Deferred compensation - restricted stock awards	(2,458)			(2,458)	
Purchase of 504,500 shares under stock repurchase plan	(19,754)	(1,009)	(18,745)		
Vested stock options	487		487		
BALANCE, SEPTEMBER 30, 2002	$ 1,330,421	$ 139,224	$ 150,592	$ 982,408	$ 58,197
BALANCE, DECEMBER 31, 2002	$ 1,324,358	$ 137,672	$ 120,577	$ 1,010,248	$ 55,861
Net income	146,169			146,169	
Unrealized gains(losses) on securities available-for-sale, net of reclassification adjustment, net of taxes (Note 8)	(23,540)				(23,540)
Comprehensive income	122,629				
Cash dividends paid:					
Common stock ($.96 per share)	(69,568)			(69,568)	
Issuance of 10,379,710 shares for bank acquisition	428,059	20,759	407,300		
Fair value of 322,528 converted options related to employee stock option plan of acquired bank	5,944		5,944		
	3,427	190	3,237		

Issuance of 95,070 shares for dividend reinvestment and stock purchase plan					
Issuance of 17,185 shares for employee stock purchase dividend reinvestment plan	675	35	640		
Issuance of 178,512 shares for employee stock option plan	3,130	357	2,773		
Issuance of 100,537 shares for restricted stock awards	3,561	202	3,359		
Deferred compensation - restricted stock awards	(870)			(870)	
Purchase of 5,500 shares under stock repurchase plan	(212)	(11)	(201)		
Vested stock options	1,189		1,189		
BALANCE, SEPTEMBER 30, 2003	**$ 1,822,322**	**$ 159,204**	**$ 544,818**	**$ 1,085,979**	**$ 32,321**

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The consolidated financial statements, which include the accounts of Mercantile Bankshares Corporation (Bankshares) (Nasdaq: MRBK) and all of its affiliates, are prepared in conformity with accounting principles generally accepted in the United States of America and follow general practice within the banking industry. In the opinion of management, the consolidated financial statements include all adjustments necessary for a fair presentation of the interim period. These adjustments are of a normal nature and include adjustments to eliminate all significant intercompany transactions. In view of the changing conditions in the national economy, the effect of actions taken by regulatory authorities and normal seasonal factors, the results for the interim period are not necessarily indicative of annual performances. For comparability, certain prior period amounts have been reclassified to conform with current period presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities in the financial statements, and the disclosure of revenue and expenses during the reporting period. These assumptions are based on information available as of the date of the financial statements and could differ from actual results. See Form 10-K for more detail.

2. Mergers and Acquisitions

In March and April 2003, Bankshares acquired in separate transactions, Boyd Watterson Asset Management, LLC (BW), an investment management firm, and Peremel & Company (Peremel), a directed and discount brokerage company. In the aggregate, the 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. The contingent payment will be recorded when amounts are resolved and become payable three years from the acquisition date. Bankshares finalized and recorded approximately $10.1 million of identified intangibles, mostly client relationships, as a result of these acquisitions. These intangibles are being amortized on a straight-line basis over a range of 3 to 8 years. Goodwill recorded on these transactions totaled approximately $17.0 million at September 30, 2003.

On August 12, 2003, Bankshares completed its acquisition of F&M Bancorp (F&M), a bank holding company headquartered in Frederick, Maryland. The total consideration to be paid to F&M stockholders in connection with the acquisition was fixed at the time the merger agreement was executed at approximately $123.5 million in cash and 10.3 million shares of Bankshares common stock. F&M transactions have been included in Bankshares financial results since August 13, 2003. Acquired assets on August 12, 2003 totaled $2.2 billion, including $1.4 billion of loans and leases; liabilities assumed were $2.0 billion, including $1.7 billion of deposits. As part of the purchase price allocation at August 12, 2003, Bankshares recorded $41.7 million of core deposit intangible, and goodwill totaled approximately $390.6 million. This is a preliminary estimate pending final analysis that is due in the fourth quarter and is subject to change pending the results. The weighted average amortization period for newly acquired core deposit intangible is seven years and is also subject to change pending final results of analysis.

On October 24, 2003, certain assets and liabilities of F&M were transferred to other Bankshares affiliates in order to align customers accounts with the Bankshares affiliate serving the geographic area where those customers reside. As a result of the transfers, future financial statements of Bankshares will not report results of the former F&M as a stand-alone entity.

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F&M, newly acquired in a business combination, falls under the guidance of the Emerging Issues Task Force (EITF) in EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* . Under EITF Issue No. 94-3, an entity recognizes a liability for an exit cost on the date that the entity commits itself to an exit plan. Exit costs are defined to include those costs recorded by F&M prior to the merger date and therefore are not included in Bankshares results of operations. F&M has recorded exit costs of $34.0 million relating to severance, systems conversion, branch consolidation and costs associated with terminating contracts (including leases). $18.1 million of these exit costs were paid as of September 30, 2003.

Bankshares exit costs, referred to herein as merger-related costs, are defined to include those costs for its branch closings and related severance, combining operations such as systems conversions, integration planning consultant s fees and marketing consultant s fees incurred by Bankshares prior to and after the merger date and are included in Bankshares results of operations. Bankshares expensed merger-related costs totaling $3.3 million and $2.4 million for the nine and three-month periods ended September 30, respectively. The costs associated with these activities are included in noninterest expenses. Merger-related expenses incurred year to date consisted largely of expenses for professional services rendered in connection with the merger integration plan. Bankshares will incur additional merger-related expenses in the fourth quarter as systems conversions, branch closings and integration of operations continue and will be reflected as expense when incurred.

Disclosed below is certain pro forma information for 2003 as if F&M had been acquired on January 1, 2003 and 2002. These results combine the historical results of F&M into Bankshares consolidated statement of income. This table reflects noninterest expenses adjusted for exit costs and intangible amortization. This is not necessarily what would have occurred had the acquisition taken place on the indicated dates and is not indicative of future results.

	For the 9 Months Ended September 30,		For the 3 Months Ended September 30,	
(Dollars in thousands)	**2003**	**2002**	**2003**	**2002**
Interest income	**$ 500,141**	$ 525,206	**$ 163,344**	$ 176,339
Interest expense	**106,950**	139,701	**32,382**	45,061
NET INTEREST INCOME	**393,191**	385,505	**130,962**	131,278
Noninterest income	**151,291**	130,633	**50,424**	43,046
Noninterest expenses	**283,219**	257,771	**100,328**	87,096
NET INCOME	**160,369**	156,069	**49,316**	53,647

Disclosed below is certain pro forma information for 2003 as if F&M had been included in each interim period presented as of January 1, 2003 and 2002. These results combine the historical results of F&M into Bankshares consolidated balance sheet statement. This is not necessarily what would have occurred had the acquisition taken place on the indicated dates.

(Dollars in thousands)	**September 30, 2003**	**December 31, 2002**	**September 30, 2002**
Total loans	**$ 9,015,082**	$ 8,617,375	$ 8,434,582
Total earning assets	**12,627,364**	12,097,158	11,808,689
Total assets	**13,876,148**	13,135,104	12,826,592
Total deposits	**10,295,842**	9,856,079	9,606,415
Shareholders equity	**1,822,322**	1,758,356	1,764,419

3. Earnings Per Share

Basic earnings per share (EPS) are computed by dividing income available to common shareholders by weighted average common shares outstanding. Diluted EPS are computed using the same components as basic EPS with the denominator adjusted for the dilutive effect of stock awards. The following tables provide reconciliation between the computation of basis EPS and diluted EPS for the nine months and quarter ended September 30, 2003 and 2002, respectively.

	For the 9 Months Ended September 30,					
	2003			2002		
(In thousands, except per share data)	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS
Basic EPS	**$ 146,169**	**70,647**	**$ 2.07**	$ 141,735	69,750	$ 2.03
Dilutive effect of stock options and restricted stock awards		**510**			530	
Diluted EPS	**$ 146,169**	**71,157**	**$ 2.05**	$ 141,735	70,280	$ 2.02

	For the 3 Months Ended September 30,					
	2003			2002		
(In thousands, except per share data)	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS
Basic EPS	**$ 47,173**	**74,253**	**$ .64**	$ 48,615	69,637	$ .70
Dilutive effect of stock options and restricted stock awards		**587**			474	
Diluted EPS	**$ 47,173**	**74,840**	**$ .63**	$ 48,615	70,111	$ .69

Antidilutive options and awards excluded in the computation of diluted earnings per share were 238,838 and 129,657 for year-to-date September 30, 2003 and 2002, respectively, and 170,313 and 261,875 for quarter-to-date September 30, 2003 and 2002, respectively.

4. Investment Securities

The amortized cost and fair value of investment securities at September 30, 2003, December 31, 2002 and September 30, 2002 are shown below:

	September 30, 2003		December 31, 2002		September 30, 2002	
(Dollars in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale						
U.S. Treasury	**$ 869,760**	**$ 901,384**	$ 1,375,703	$ 1,421,890	$ 1,437,544	$ 1,488,636

U.S. Government agencies		**752,861**		**773,894**		695,970		727,627		677,547		708,647
Mortgage-backed securities		**1,243,745**		**1,240,215**		341,805		348,323		194,984		201,718
States and political subdivisions		**88,691**		**90,696**		549		577		549		579
Other investments		**121,377**		**122,405**		7,683		12,775		7,716		12,361
Total	**$**	**3,076,434**	**$**	**3,128,594**	$	2,421,710	$	2,511,192	$	2,318,340	$	2,411,941
Securities held-to-maturity												
States and political subdivisions	**$**	**33,421**	**$**	**36,030**	$	38,299	$	41,150	$	36,993	$	40,071
Other investments		**22,636**		**22,636**		15,092		15,092		15,461		15,461
Total	**$**	**56,057**	**$**	**58,666**	$	53,391	$	56,242	$	52,454	$	55,532

5. Impaired Loans

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. Generally, a loan is considered impaired once either principal or interest payments become 90 days past due at the end of a calendar quarter. A loan may be considered impaired sooner if, in management s judgment, such action is warranted. 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 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. If a loan is deemed to be impaired a valuation allowance is established for the amount of the impairment. Accrued interest on impaired loans is reversed and is recognized on a cash basis. Information with respect to impaired loans and the related valuation allowance (if the measure of the impaired loan is less that the recorded investment) at September 30, and June 30, 2003 and at the end of December 2002, is shown below. See Form 10-K for more detail.

(Dollars in thousands)		**September 30, 2003**		**June 30, 2003**		**December 31, 2002**
Impaired loans with a specific valuation allowance	**$**	**27,869**	$	18,523	$	13,751
All other impaired loans		**18,609**		15,066		16,813
Total impaired loans	**$**	**46,478**	$	33,589	$	30,564
Specific allowance for loan losses applicable to impaired loans	**$**	**14,766**	$	8,840	$	5,251
Allowance for loan losses applicable to other than impaired loans		**140,988**		133,421		133,350
Total allowance for loan losses	**$**	**155,754**	$	142,261	$	138,601
Year-to-date interest income on impaired loans recorded on the cash basis	**$**	**220**	$	155	$	563
Year-to-date average recorded investment in impaired loans during the period	**$**	**29,194**	$	26,438	$	53,777
Quarter-to-date interest income on impaired loans recorded on the cash basis	**$**	**65**	$	58	$	143
Quarter-to-date average recorded investment in impaired loans during the period	**$**	**34,707**	$	28,822	$	44,263

Note: 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 allowance for loan losses related to these loans is included in the allowance for loan losses applicable to other than impaired loans.

6. Commitments

Various commitments to extend credit (lines of credit) are made in the normal course of the banking business. Total unused lines of credit approximated $3.4 billion, $3.0 billion and $2.9 billion at September 30, 2003, December 31, 2002 and September 30, 2002, respectively. The lines of credit commitments are shown at fair value. These amounts are not recorded on the books of Bankshares. In addition, letters of credit are issued for the benefit of customers by affiliated banks. These outstanding letters of credit were $284.3 million at September 30, 2003, $241.1 million at December 31, 2002 and $232.9 million at September 30, 2002. In accordance with FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, the fees received for issuing letters of credit are deferred and amortized over the life of the commitment. The letters of credit at September 30, 2003 had a carrying value of $745 thousand representing unamortized fees.

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Bankshares mortgage banking subsidiary, as a Fannie Mae Delegated Underwriting and Servicing lender, has a loss sharing arrangement for loans originated on behalf of and sold to Fannie Mae. The unamortized principal balance of the underlying loans totaled $150.0 million at September 30, 2003. No allowance has been established for possible losses since there have been no losses recognized during the six-year history of the arrangement and none are expected as of September 30, 2003. The mortgage subsidiary has also originated and loans sold with recourse in the event of foreclosure on the underlying real estate. The unamortized amount of principal balance of loans sold with recourse totaled $2.5 million at September 30, 2003. These mortgages are generally in good standing and are well collateralized, no loss has ensued and no future loss is expected.

Bankshares has committed to invest funds in third-party private equity investments. At September 30, 2003, December 31, 2002 and September 30, 2002, $17.8 million, $15.2 million and $10.4 million, respectively, remained unfunded.

7. Intangible Assets

The following table discloses the gross carrying amount and accumulated amortization of intangible assets subject to amortization at September 30, 2003 and December 31, 2002:

	September 30, 2003			December 31, 2002		
(Dollars in thousands)	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Amount**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Amount**
Deposit intangibles	**$ 55,556**	**$ (7,679)**	**$ 47,877**	$ 13,846	$ (6,581)	$ 7,265
Mortgage servicing rights	**1,914**	**(1,524)**	**390**	1,543	(1,282)	261
Customer list	**10,110**	**(1,018)**	**9,092**	50	(46)	4
Total	**$ 67,580**	**$ (10,221)**	**$ 57,359**	$ 15,439	$ (7,909)	$ 7,530

The projections of amortization expense shown for mortgage servicing rights are based on asset balances and the interest rate environment as of September 30, 2003. Future amortization expense may be significantly different depending upon changes in the mortgage servicing portfolio, mortgage interest rates and market conditions.

The following table shows the current period and estimated future amortization expense for amortized intangible assets. Core deposit intangibles are amortized based on useful lives of up to seven years. Bankshares recorded an estimated $41.7 million of core deposit intangibles in conjunction with the F&M acquisition. Future estimated amortization expense amounts are contingent on the final results of the valuation study being conducted in concert with the previously mentioned planned transfer of selected F&M assets and liabilities to Bankshares affiliates in the fourth quarter. Management reviews other intangible assets for impairment yearly (except mortgage servicing rights, which are reviewed monthly), or whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. For those intangible assets subject to amortization, impairment is indicated if the sum of undiscounted estimated future net cash flow is less than the carrying amount of the asset. Impairment is recognized by accelerating the write off of the asset to the extent that the carrying value exceeds the estimated fair value.

(Dollars in thousands)		Core deposit intangibles	Mortgage servicing intangibles	Customer list intangibles	Total
Nine months ended September 30, 2003 (actual)		$ 1,904	$ 218	$ 975	$ 3,097
Quarter ended December 31, 2003 (estimated)		1,883	98	420	2,727
Estimate for year ended December 31,	2003	3,787	316	1,395	5,824
	2004	7,531	292	1,659	9,580
	2005	7,531		1,659	9,190
	2006	7,531		1,494	9,025
	2007	7,384		1,323	8,707
	2008	6,669		1,317	7,986

8. Comprehensive Income

The following table summarizes the related tax effect of unrealized gains (losses) on securities available-for-sale for the nine months ended September 30, 2003 and 2002. The net amount is included in accumulated other comprehensive income (loss) in the Statement of Changes in Consolidated Shareholders Equity.

	For the 9 Months Ended September 30,					
	2003			2002		
(Dollars in thousands)	Pretax Amount	Tax (Expense) Benefit	Net Amount	Pretax Amount	Tax (Expense) Benefit	Net Amount
Unrealized gains (losses) on securities available-for-sale:						
Unrealized holding gains (losses) arising during the period	**$ (30,309)**	**$ 11,010**	**$ (19,299)**	$ 51,629	$ (19,150)	$ 32,479
Reclassification adjustment for (gains) losses included in net income	**(7,015)**	**2,774**	**(4,241)**	(846)	335	(511)
Total	**$ (37,324)**	**$ 13,784**	**$ (23,540)**	$ 50,783	$ (18,815)	$ 31,968

9. Capital Adequacy

Bankshares and its bank affiliates are subject to various regulatory capital adequacy requirements administered by federal and state banking agencies. These requirements include maintaining certain capital ratios above minimum levels. These capital ratios include tier I capital and total risk-based capital as percents of net risk-weighted assets and tier I capital as a percent of adjusted average total assets (leverage ratio). The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00%, for the tier I capital, total capital and leverage ratios, respectively. To be categorized as *well capitalized,* a bank must maintain minimum ratios of 6.00%, 10.00% and 5.00%, for its tier I capital, total capital and leverage ratios, respectively. As of September 30, 2003, Bankshares and all of its bank affiliates except one, F&M, exceeded all capital adequacy requirements to be considered well capitalized. Although adequately capitalized, F&M did not meet the total risk-based capital threshold to be considered well capitalized. As part of the purchase price allocation F&M recorded core deposit intangibles of $41.7 million, which is deducted from regulatory capital. This deduction reduced F&M s total risk-based capital ratio to 9.3%, slightly below the 10.0% threshold needed to be considered well capitalized. As a result of the transfers referred to in Footnote 2 to the Consolidated Financial

Statements, F&M s total risk-based capital ratio was 18.0% at October 31, 2003.

Capital ratios and the amounts used to calculate them are presented in the following table for Bankshares and Mercantile-Safe Deposit & Trust Company (MSD&T), the lead bank, as of September 30, 2003 and December 31, 2002.

	September 30, 2003		December 31, 2002	
(Dollars in thousands)	**Bankshares**	**MSD&T**	**Bankshares**	**MSD&T**
Tier I capital	**$ 1,215,504**	$ 394,407	$ 1,151,831	$ 430,375
Total risk-based capital	**1,638,254**	438,456	1,250,550	473,185
Net risk-weighted assets	**9,824,821**	3,515,440	7,677,476	3,407,691
Adjusted average total assets	**11,966,146**	4,473,499	10,281,071	4,246,480
Tier I capital ratio	**12.37%**	11.22%	15.00%	12.63%
Total capital ratio	**16.67%**	12.47%	16.29%	13.89%
Leverage ratio	**10.16%**	8.82%	11.20%	10.13%

10. Segment Reporting

Operating segments as defined by SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information* are components of an enterprise with separate financial information. The component engages in business activities, from which it derives revenues and incurs expenses and whose operating results management relies on for decision-making and performance assessment. Bankshares has three reportable segments the twenty Community Banks, the Banking Division of MSD&T and the Investment and Wealth Management Division (IWM) of MSD&T.

The following table presents selected segment information for the nine months ended September 30, 2003 and 2002. The components in the Other column consist of amounts for the nonbanking affiliates and intercompany eliminations. Certain expense amounts such as operations overhead have been reclassified from internal financial reporting in order to provide for full cost absorption. These reclassifications are shown in the Adjustments line. F&M is included in the column Community Banks whereas BW and Peremel are included in the column MSD&T IWM .

	For the 9 Months Ended September 30, 2003					
(Dollars in thousands)	**MSD&T Banking**	**MSD&T IWM**	**Total MSD&T**	**Community Banks**	**Other**	**Total**
Net interest income	**$ 106,701**	**$**	**$ 106,701**	**$ 240,278**	**$ (898)**	**$ 346,081**
Provision for loan losses	**(5,253)**		**(5,253)**	**(3,819)**		**(9,072)**
Noninterest income	**32,070**	**57,560**	**89,630**	**50,151**	**(10,588)**	**129,193**
Noninterest expenses	**(69,145)**	**(50,014)**	**(119,159)**	**(127,627)**	**8,767**	**(238,019)**
Adjustments	**13,589**	**(2,457)**	**11,132**	**(7,796)**	**(3,336)**	
Income (loss) before income taxes	**77,962**	**5,089**	**83,051**	**151,187**	**(6,055)**	**228,183**
Income tax (expense) benefit	**(28,075)**	**(2,035)**	**(30,110)**	**(52,125)**	**221**	**(82,014)**
Net income (loss)	**$ 49,887**	**$ 3,054**	**$ 52,941**	**$ 99,062**	**$ (5,834)**	**$ 146,169**
Average assets			**$ 4,390,264**	**$ 7,156,379**	**$ (145,612)**	**$ 11,401,031**

Average equity	**454,583**	**846,404**	**90,134**	**1,391,121**

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	For the 9 Months Ended September 30, 2002					
(Dollars in thousands)	**MSD&T Banking**	**MSD&T IWM**	**Total MSD&T**	**Community Banks**	**Other**	**Total**
Net interest income	$ 109,942	$	$ 109,942	$ 221,296	$ (1,711)	$ 329,527
Provision for loan losses	(6,800)		(6,800)	(4,643)		(11,443)
Noninterest income	29,987	51,195	81,182	37,375	(11,527)	107,030
Noninterest expenses	(68,215)	(32,261)	(100,476)	(112,988)	10,706	(202,758)
Adjustments	12,720	(1,252)	11,468	(6,376)	(5,092)	
Income (loss) before income taxes	77,634	17,682	95,316	134,664	(7,624)	222,356
Income tax (expense) benefit	(28,045)	(7,073)	(35,118)	(47,035)	1,532	(80,621)
Net income (loss)	$ 49,589	$ 10,609	$ 60,198	$ 87,629	$ (6,092)	$ 141,735
Average assets			$ 4,101,243	$ 6,157,184	$ (253,236	