

SEVERN BANCORP INC
Form 10-Q
May 12, 2016

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended March 31, 2016

or

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

For the transition period from _____ to _____ .

Commission File Number 0-49731

SEVERN BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland

52-1726127

(State or other jurisdiction of incorporation or organization) (I.R.S. employer identification no.)

200 Westgate Circle, Suite 200

Annapolis, Maryland

21401

(Address of principal executive offices) (Zip Code)

410-260-2000

(Registrant's telephone number, including area code)

N/A

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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Large accelerated filer

Accelerated filer

Non- accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

Number of shares of the registrant's Common Stock, \$0.01 par value, outstanding as of the close of business on May 12, 2016: 12,104,379 shares.

SEVERN BANCORP, INC. AND SUBSIDIARIES

Table of Contents

PART I – FINANCIAL INFORMATION	Page
Item 1. Financial Statements (Unaudited)	
<u>Consolidated Statements of Financial Condition as of March 31, 2016 and December 31, 2015</u>	1
<u>Consolidated Statements of Income for the Three Months Ended March 31, 2016 and 2015</u>	2
<u>Consolidated Statements of Stockholders' Equity for the Three Months Ended March 31, 2016 and 2015</u>	3
<u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2016 and 2015</u>	4
<u>Notes to Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	38
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	47
Item 4. <u>Controls and Procedures</u>	47
PART II – OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	47
Item 1A. <u>Risk Factors</u>	48
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	48
Item 3. <u>Defaults Upon Senior Securities</u>	48
Item 4. <u>Mine Safety Disclosures</u>	48
Item 5. <u>Other Information</u>	48
Item 6. <u>Exhibits</u>	48
<u>SIGNATURES</u>	49

Table of Contents

PART I- FINANCIAL INFORMATION

Item 1. Financial Statements

SEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandCONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (UNAUDITED)

(dollars in thousands, except per share amounts)

	March 31, 2016	December 31, 2015
ASSETS		
Cash and due from banks	\$39,126	\$ 28,366
Interest-bearing deposits in other banks	9,579	15,225
Federal funds sold	4,393	-
Cash and cash equivalents	53,098	43,591
Investment securities held to maturity (fair value: \$75,856 at March 31, 2016; \$76,310 at December 31, 2015)	74,757	76,133
Loans held for sale	5,724	13,203
Loans receivable, net of allowance for loan losses of \$8,633 and \$8,758, respectively	592,655	589,656
Premises and equipment, net	24,064	24,290
Foreclosed real estate	1,737	1,744
Federal Home Loan Bank stock, at cost	5,613	5,626
Accrued interest receivable and other assets	7,786	7,836
Total assets	\$765,434	\$ 762,079
LIABILITIES AND STOCKHOLDERS' EQUITY		
<u>Liabilities</u>		
Deposits	\$524,733	\$ 523,771
Long-term borrowings	115,000	115,000
Subordinated debentures	24,119	24,119
Accrued interest payable and other liabilities	14,697	12,733
Total liabilities	678,549	675,623
<u>Stockholders' Equity</u>		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized:		
Preferred stock series "A", 437,500 shares issued and outstanding; \$3,500 liquidation preference	4	4
Preferred stock series "B", 23,393 shares issued and outstanding; \$23,393 liquidation preference	-	-
Common stock, \$0.01 par value, 20,000,000 shares authorized; 10,088,879 shares issued and outstanding	101	101
Additional paid-in capital	76,451	76,335
Retained earnings	10,329	10,016
Total stockholders' equity	86,885	86,456

Total liabilities and stockholders' equity	\$765,434	\$ 762,079
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The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandCONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(dollars in thousands, except per share data)

	For the Three Months Ended March 31,	
	2016	2015
<u>Interest Income</u>		
Loans, including fees	\$ 7,107	\$ 7,546
Securities, taxable	311	233
Other	86	81
Total interest income	7,504	7,860
<u>Interest Expense</u>		
Deposits	979	1,004
Long-term/short-term borrowings and subordinated debentures	1,290	1,197
Total interest expense	2,269	2,201
Net interest income	5,235	5,659
Provision for loan losses	-	100
Net interest income after provision for loan losses	5,235	5,559
<u>Non-interest Income</u>		
Mortgage banking activities	692	470
Real estate commissions	118	107
Real estate management fees	165	158
Other	246	165
Total non-interest income	1,221	900
<u>Non-Interest Expenses</u>		
Compensation and related expenses	3,636	3,810
Occupancy	452	425
Legal	130	62
Foreclosed real estate, net	45	(65)
FDIC assessments and regulatory expense	130	318
Professional fees	172	266
Advertising	133	142
Online charges	257	209
Credit report and appraisal fees	103	130
Other	491	296
Total non-interest expenses	5,549	5,593
Income before income tax provision	907	866
Income tax provision	-	1
Net income	\$ 907	\$ 865
Amortization of discount on preferred stock	(68)	(68)
Dividends on preferred stock	(526)	(527)
Net income available to common stockholders	\$ 313	\$ 270
Basic income per share	\$ 0.03	\$ 0.03

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Diluted income per share	\$ 0.03	\$ 0.03
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The accompanying notes to consolidated financial statements are an integral part of these statements.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandCONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (UNAUDITED)

(dollars in thousands, except per share data)

Three Months Ended March 31, 2016

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
Balance - December 31, 2015	\$ 4	\$ 101	\$ 76,335	\$ 10,016	\$ 86,456
Net Income	-	-	-	907	907
Stock-based compensation	-	-	48	-	48
Dividend declared on Series B preferred stock	-	-	-	(526)	(526)
Amortization of discount on Series B preferred stock	-	-	68	(68)	-
Balance – March 31, 2016	\$ 4	\$ 101	\$ 76,451	\$ 10,329	\$ 86,885

Three Months Ended March 31, 2015

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
Balance - December 31, 2014	\$ 4	\$ 101	\$ 75,848	\$ 7,857	\$ 83,810
Net Income	-	-	-	865	865
Exercise of stock options (20,500 shares)	-	-	93	-	93
Stock-based compensation	-	-	34	-	34
Dividend declared on Series B preferred stock	-	-	-	(527)	(527)
Amortization of discount on Series B preferred stock	-	-	68	(68)	-
Balance – March 31, 2015	\$ 4	\$ 101	\$ 76,043	\$ 8,127	\$ 84,275

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

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandCONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(dollars in thousands)

	For the Three Months Ended March 31,	
	2016	2015
<u>Cash Flows from Operating Activities</u>		
Net income	\$ 907	\$ 865
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of deferred loan fees	(297)	(297)
Net amortization of premiums and discounts	104	91
Provision for loan losses	-	100
Provision for depreciation	286	280
Provision for foreclosed real estate losses	70	-
Gain on sale of mortgage loans	(692)	(470)
Gain on sale of foreclosed real estate	(57)	(99)
Proceeds from loans sold to others	36,580	29,473
Loans originated for sale	(28,409)	(34,897)
Stock-based compensation expense	48	34
Decrease in accrued interest receivable and other assets	50	1,689
Increase in accrued interest payable and other liabilities	1,438	1,587
Net cash provided by (used in) operating activities	10,028	(1,644)
<u>Cash Flows from Investing Activities</u>		
Purchase of investment securities held to maturity	(1,021)	-
Proceeds from maturing investment securities held to maturity	1,000	1,000
Principal collected on mortgage-backed securities held to maturity	1,293	606
Net (increase) decrease in loans	(3,286)	14,466
Proceeds from sale of foreclosed real estate	578	821
Investment in premises and equipment	(60)	(107)
Redemption of FHLB stock	13	353
Net cash (used in) provided by investing activities	(1,483)	17,139

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) CONTINUED

(dollars in thousands)

	For the Three Months Ended March 31,	
	2016	2015
<u>Cash Flows from Financing Activities</u>		
Net increase in deposits	962	2,721
Proceeds from exercise of options	-	93
Net cash provided by financing activities	962	2,814
Increase in cash and cash equivalents	9,507	18,309
Cash and cash equivalents at beginning of year	43,591	33,335
Cash and cash equivalents at end of period	\$ 53,098	\$ 51,644

Supplemental disclosure of cash flows information:

Cash paid during period for:

Interest	\$ 1,962	\$ 1,994
Income taxes	\$ -	\$ 1
Transfer of loans to foreclosed real estate	\$ 584	\$ 986

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 - Principles of Consolidation

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

Note 2 - Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with GAAP for interim financial information and in accordance with the instructions to Form 10-Q. Accordingly, they do not include all of the disclosures required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation of the results of operations for the interim periods presented have been made. Such adjustments were of a normal recurring nature. The results of operations for the three months ended March 31, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2016 or any other interim period. The unaudited consolidated financial statements for the three months ended March 31, 2016 should be read in conjunction with the audited consolidated financial statements and related notes, which were included in Bancorp’s Annual Report on Form 10-K for the fiscal year ended December 31, 2015. These consolidated financial statements consider events that occurred through the date the consolidated financial statements were issued.

Note 3 - Cash Flow Presentation

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

Note 4 – Reclassifications

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 5 - Earnings Per Share

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

Not included in the diluted earnings per share calculation for the three month periods ended March 31, 2016 and March 31, 2015, because they were anti-dilutive, were 136,500 and 172,000 shares, respectively, of common stock issuable upon exercise of outstanding stock options, 556,976 shares of common stock issuable upon the exercise of a warrant and 437,500 shares of common stock issuable upon conversion of Bancorp's Series A Preferred Stock.

	Three Months Ended March 31,	
	2016	2015
Common shares – weighted average (basic)	10,088,879	10,070,796
Common share equivalents – weighted average	39,372	22,455
Common shares – diluted	10,128,251	10,093,251

Note 6 - Guarantees

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

Note 7 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on Bancorp's consolidated financial statements.

As of March 31, 2016, Bancorp's reservable liability was below the threshold established by the Federal Reserve Bank and therefore, Bancorp was not required to maintain reserves (in the form of deposits with the Federal Reserve Bank or a correspondent bank on behalf of the Federal Reserve Bank.)

Federal banking agencies have adopted proposals that have substantially amended the regulatory capital rules applicable to Bancorp and the Bank. The amendments implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The amended rules establish new higher capital ratio requirements, narrow the definitions of capital, impose new operating restrictions on banking organizations with insufficient capital buffers and increase the risk weighting of certain assets. The amended rules were effective with respect to Bancorp and the Bank in January 2015, with certain requirements to be phased in beginning in 2016.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 7 - Regulatory Matters – Continued

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined).

As of March 31, 2016, the most recent notification from the regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1 and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table.

Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. We have included the 0.625% increase for 2016 in our minimum capital adequacy ratios in the table below. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of March 31, 2016, all capital adequacy requirements under the Basel III Capital Rules have been met on a fully phased-in basis as if all such requirements were currently in effect.

	Actual		For Capital Adequacy Purposes		Minimum Capital Adequacy with Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	%	Amount	%	Amount	%	Amount	%
	(dollars in thousands)							
March 31, 2016								
Tangible (1)	\$ 114,304	15.0%	\$ 11,408	1.5 %	N/A	N/A	N/A	N/A
Tier 1 capital (2)	114,304	20.6%	33,247	6.0 %	\$ 36,711	6.6 %	\$ 44,330	8.0 %
Common Equity Tier 1 (2)	114,304	20.6%	24,935	4.5 %	28,399	5.1 %	36,018	6.5 %
Leverage (1)	114,304	15.0%	30,421	4.0 %	37,175	4.6 %	38,027	5.0 %
Total (2)	121,253	21.9%	44,330	8.0 %	47,793	8.6 %	55,412	10.0 %

(1) To adjusted total assets.

(2) To risk-weighted assets.

Note 8 - Stock-Based Compensation

Bancorp has a stock-based compensation plan for directors, officers, and other key employees of Bancorp. The aggregate number of shares of common stock that may be issued with respect to the awards granted under the plan is 500,000 plus any shares forfeited under Bancorp's old stock-based compensation plan. Under the terms of the stock-based compensation plan, Bancorp has the ability to grant various stock compensation incentives, including stock options, stock appreciation rights, and restricted stock. The stock-based compensation is granted under terms

and conditions determined by the Compensation Committee of the Board of Directors. Under the stock-based compensation plan, stock options generally have a maximum term of ten years, and are granted with an exercise price at least equal to the fair market value of the common stock on the date the options are granted. Generally, options granted to directors, officers and employees of Bancorp vest over a five-year period, although the Compensation Committee has the authority to provide for different vesting schedules.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 8 - Stock-Based Compensation - Continued

Bancorp follows FASB ASC 718, "Compensation – Stock Compensation", to account for stock-based compensation. FASB ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statement of operations at fair value. FASB ASC 718 requires an entity to recognize the expense of employee services received in share-based payment transactions and measure the expense based on the grant date fair value of the award. The expense is recognized over the period during which an employee is required to provide service in exchange for the award. There were no options granted during the three months ended March 31, 2016 and 2015.

Stock-based compensation expense for the three months ended March 31, 2016 and 2015 totaled \$48,000 and \$34,000, respectively. There were no options exercised during the three months ended March 31, 2016 and 20,500 options exercised during the three months ended March 31, 2015.

Information regarding Bancorp's stock-based compensation plan as of and for the three months ended March 31, 2016 is as follows:

	2016	
	Shares	Weighted Average Price
Options outstanding, December 31, 2015	339,800	\$ 4.83
Options granted	-	-
Options exercised	-	-
Options forfeited	-	-
Options outstanding, March 31, 2016	339,800	\$ 4.83
Options exercisable, March 31, 2016	120,220	\$ 4.27

The aggregate intrinsic value of the options outstanding as of March 31, 2016 and December 31, 2015 was \$169,000 and \$323,000, respectively. The aggregate intrinsic value of the options exercisable as of March 31, 2016 and December 31, 2015 was \$102,000 and \$165,000 respectively.

The following table summarizes the nonvested options in Bancorp's stock option plan as of March 31, 2016.

	Shares	Weighted Average Grant Date Exercise Price
Nonvested options outstanding, December 31, 2015	235,570	\$ 5.13
Nonvested options granted	-	-
Nonvested options vested	(15,990)	\$ 4.93
Nonvested options forfeited	-	-
Nonvested options outstanding, March 31, 2016	219,580	\$ 5.14

As of March 31, 2016, there was \$642,000 of total unrecognized stock-based compensation expense related to nonvested stock options, which is expected to be recognized over a period of fifty-seven months.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 9 - Investment Securities

The amortized cost and fair value of investment securities held to maturity are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>March 31, 2016:</u>				
US Treasury securities	\$ 20,037	\$ 353	\$ -	\$20,390
US Agency securities	21,023	353	-	21,376
US Government sponsored mortgage-backed securities	33,697	393	-	34,090
Total	\$ 74,757	\$ 1,099	\$ -	\$75,856

December 31, 2015:

US Treasury securities	\$ 21,057	\$ 276	\$ 8	\$21,325
US Agency securities	20,011	139	76	20,074
US Government sponsored mortgage-backed securities	35,065	41	195	34,911
Total	\$ 76,133	\$ 456	\$ 279	\$76,310

The following table shows fair value and unrealized losses, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position as of March 31, 2016 and December 31, 2015. There were no securities in a gross unrealized loss position at March 31, 2016. Included in the table are: four US Treasury securities, thirteen Agency securities and twelve Mortgage-backed securities were in a gross unrealized loss position at December 31, 2015. Management believes that the unrealized losses in 2015 were the result of interest rate levels differing from those existing at the time of purchase of the securities and actual and estimated prepayment speeds. The Bank does not consider any of these securities to be other than temporarily impaired at December 31, 2015, because the unrealized losses were related primarily to changes in market interest rates and widening of sector spreads and were not necessarily related to the credit quality of the issuers of the securities.

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

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 9 - Investment Securities – Continued

	Less than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(dollars in thousands)						
<u>March 31, 2016:</u>						
US Treasury securities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
US Agency securities	-	-	-	-	-	-
US Government sponsored mortgage-backed securities	-	-	-	-	-	-
Total	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

	Less than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(dollars in thousands)						
<u>December 31, 2015:</u>						
US Treasury securities	\$3,992	\$ 8	\$ -	\$ -	\$3,992	\$ 8
US Agency securities	12,958	76	-	-	12,958	76
US Government sponsored mortgage-backed securities	31,091	195	-	-	31,091	195
Total	\$48,041	\$ 279	\$ -	\$ -	\$48,041	\$ 279

The amortized cost and estimated fair value of debt securities at March 31, 2016, by contractual maturity are shown in the following table. Actual maturities may differ from contractual maturities, because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Held to Maturity (dollars in thousands)	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 11,048	\$ 11,110
Due from one year to five years	28,055	28,531
Due from five years to ten years	1,957	2,125
US Government sponsored mortgage-backed securities	33,697	34,090
	\$ 74,757	\$ 75,856

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 -Loans Receivable

Loans receivable, included unfunded commitments consist of the following:

	March 31 2016	December 31 2015
	(dollars in thousands)	
Residential mortgage, total	\$ 284,701	\$ 285,930
Individually evaluated for impairment	26,477	26,087
Collectively evaluated for impairment	258,224	259,843
Construction, land acquisition and development, total	60,053	77,478
Individually evaluated for impairment	351	309
Collectively evaluated for impairment	59,702	77,169
Land, total	31,610	28,677
Individually evaluated for impairment	1,444	1,608
Collectively evaluated for impairment	30,166	27,069
Lines of credit, total	21,858	20,188
Individually evaluated for impairment	150	299
Collectively evaluated for impairment	21,708	19,889
Commercial real estate, total	186,270	174,912
Individually evaluated for impairment	3,800	6,321
Collectively evaluated for impairment	182,470	168,591
Commercial non-real estate, total	13,156	9,296
Individually evaluated for impairment	99	122
Collectively evaluated for impairment	13,057	9,174
Home equity, total	23,442	24,529
Individually evaluated for impairment	1,929	2,285
Collectively evaluated for impairment	21,513	22,244
Consumer, total	1,141	1,224
Individually evaluated for impairment	215	10
Collectively evaluated for impairment	926	1,214
Total Loans	622,231	622,234
<u>Less</u>		
Unfunded commitments included above	(18,220)	(21,101)
	604,011	601,133
Individually evaluated for impairment	34,465	37,041
Collectively evaluated for impairment	569,546	564,092
	604,011	601,133
Allowance for loan losses	(8,633)	(8,758)

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Deferred loan origination fees and costs, net	(2,723)	(2,719)
Net Loans	\$592,655	\$ 589,656

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 Loans Receivable - Continued

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

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

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

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

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

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

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

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

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

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

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

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

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

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

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

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

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

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

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

The loan has been foreclosed on. Once the loan has been transferred from the Loans Receivable to Foreclosed Real Estate, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.

An agreement to accept less than the recorded balance of the loan has been made with the borrower. Once an agreement has been finalized, and any proceeds from the borrower are received, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.

The loan is considered to be impaired collateral dependent and its collateral valuation is less than the recorded balance. The loan is written down for accounting purposes by the amount of the difference between the recorded balance and collateral value.

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

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

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

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable – Continued

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

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

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

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

Bancorp recognized \$61,000 and \$57,000 of interest income and capitalized interest in its loan portfolio from interest reserves during the three months ended March 31, 2016 and 2015, respectively. None of the loans where interest reserves were recorded as capitalized interest were non-performing.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following is a summary of the allowance for loan losses for the three month periods ended March 31, 2016 and 2015 (dollars in thousands):

	Total	Residential Mortgage	Construction Acquisition Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Three months March 2016									
Beginning Balance	\$8,758	\$ 4,188	\$ 446	\$510	\$ 57	\$ 2,792	\$ 234	\$528	\$ 3
Provision	-	93	(111)	174	(20)	(397)	112	149	-
Charge-offs	(232)	(140)	-	-	-	(47)	(17)	(28)	-
Recoveries	107	82	-	-	5	-	19	1	-
Ending Balance	\$8,633	\$ 4,223	\$ 335	\$684	\$ 42	\$ 2,348	\$ 348	\$650	\$ 3
Ending balance related to:									
Allowance on loans individually evaluated for impairment	\$2,084	\$ 1,760	\$ -	\$81	\$ 15	\$ 221	\$ 4	\$2	\$ 1
Allowance on loans collectively evaluated for impairment	\$6,549	\$ 2,463	\$ 335	\$603	\$ 27	\$ 2,127	\$ 344	\$648	\$ 2
Three months March 2015									
Beginning Balance	\$9,435	\$ 4,664	\$ 362	\$646	\$ 12	\$ 2,504	\$ 280	\$963	\$ 4
Provision	100	(22)	6	(308)	(5)	294	78	58	(1)
Charge-offs	(626)	(168)	-	-	-	-	(1)	(457)	-
Recoveries	55	17	-	-	10	-	25	3	-
Ending Balance	\$8,964	\$ 4,491	\$ 368	\$338	\$ 17	\$ 2,798	\$ 382	\$567	\$ 3
Ending balance related to:									
Allowance on loans individually evaluated for impairment	\$2,254	\$ 1,969	\$ -	\$49	\$ -	\$ 220	\$ 14	\$-	\$ 2
Allowance on loans collectively evaluated for impairment	\$6,710	\$ 2,522	\$ 368	\$289	\$ 17	\$ 2,578	\$ 368	\$567	\$ 1

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

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

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

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following tables summarize impaired loans at March 31, 2016 and December 31, 2015 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
March 31, 2016					
Residential mortgage	\$ 11,386	\$ 1,760	\$ 15,091	\$ 26,477	\$ 27,159
Construction, acquisition and development	-	-	351	351	351
Land	647	81	797	1,444	1,557
Lines of credit	150	15	-	150	150
Commercial real estate	2,142	221	1,658	3,800	3,872
Commercial non-real estate	99	4	-	99	99
Home equity	16	2	1,913	1,929	2,515
Consumer	10	1	205	215	215
Total impaired loans	\$ 14,450	\$ 2,084	\$ 20,015	\$ 34,465	\$ 35,918

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
December 31, 2015					
Residential mortgage	\$ 11,885	\$ 1,838	\$ 14,202	\$ 26,087	\$ 26,656
Construction, acquisition and development	-	-	309	309	309
Land	639	78	969	1,608	1,723
Lines of credit	299	30	-	299	299
Commercial real estate	3,214	328	3,107	6,321	6,469
Commercial non-real estate	103	5	19	122	123
Home equity	16	2	2,269	2,285	3,251
Consumer	10	1	-	10	10
Total impaired loans	\$ 16,166	\$ 2,282	\$ 20,875	\$ 37,041	\$ 38,840

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following tables summarize average impaired loans for the three month periods ended March 31, 2016 and 2015 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three months ended March 31, 2016						
Residential mortgage	\$ 11,433	\$ 123	\$ 15,217	\$ 168	\$ 26,650	\$ 291
Construction, acquisition and development	-	-	331	4	331	4
Land	649	8	878	10	1,527	18
Lines of credit	150	2	99	-	249	2
Commercial real estate	2,148	27	2,381	16	4,529	43
Commercial non-real estate	100	1	18	-	118	1
Home equity	16	1	2,148	20	2,164	21
Consumer	10	-	68	-	78	-
Total impaired loans	\$ 14,506	\$ 162	\$ 21,140	\$ 218	\$ 35,646	\$ 380
	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three months ended March 31, 2015						
Residential mortgage	\$ 13,648	\$ 136	\$ 15,343	\$ 148	\$ 28,991	\$ 284
Construction, acquisition and development	-	-	1,157	9	1,157	9
Land	354	3	1,676	22	2,030	25
Lines of credit	-	-	454	13	454	13
Commercial real estate	2,518	31	1,953	40	4,471	71
Commercial non-real estate	270	2	-	13	270	15
Home equity	352	-	3,077	38	3,429	38
Consumer	12	-	-	-	12	-
Total impaired loans	\$ 17,154	\$ 172	\$ 23,660	\$ 283	\$ 40,814	\$ 455

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Bancorp recognized \$380,000 and \$455,000 of interest income on impaired loans using a cash-basis method of accounting for the three months ended March 31, 2016 and 2015, respectively. Bancorp did not record any interest income attributable to the change in present value due to the passage of time. Bancorp evaluates its impaired loans and assesses them based on either discounted cash flows or if it deems its loans to be collateral based, assesses impairment based on the net value of the underlying collateral.

Included in the above impaired loans amount at March 31, 2016 was \$26,191,000 of loans that are not in non-accrual status. In addition, there was a total of \$26,477,000 of residential real estate loans included in impaired loans at March 31, 2016, of which \$20,821,000 were to consumers and \$5,656,000 to builders. The collateral supporting impaired collateral dependent loans is individually reviewed by management to determine its estimated fair market value, less estimated disposal cost and a charge off is taken, if necessary, for the difference between the carrying amount of any loan and the estimated fair value of the collateral less estimated disposal cost.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of March 31, 2016 and December 31, 2015. Included in the Pass column were \$18,220,000 and \$21,101,000 in unfunded commitments at March 31, 2016 and December 31, 2015, respectively (dollars in thousands):

	Pass	Special Mention	Substandard	Doubtful	Total
March 31, 2016					
Residential mortgage	\$270,487	\$8,146	\$ 6,068	\$ -	\$284,701
Construction, acquisition and development	59,702	71	280	-	60,053
Land	30,715	489	406	-	31,610
Lines of credit	21,344	364	150	-	21,858
Commercial real estate	172,572	12,307	1,391	-	186,270
Commercial non-real estate	12,815	116	225	-	13,156
Home equity	21,356	587	1,499	-	23,442
Consumer	935	-	206	-	1,141
Total loans	\$589,926	\$22,080	\$ 10,225	\$ -	\$622,231

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2015					
Residential mortgage	\$268,583	\$12,457	\$ 4,890	\$ -	\$285,930
Construction, acquisition and development	77,168	71	239	-	77,478
Land	26,845	1,268	564	-	28,677
Lines of credit	19,521	368	299	-	20,188
Commercial real estate	155,766	13,208	5,938	-	174,912
Commercial non-real estate	9,151	125	20	-	9,296
Home equity	22,018	588	1,923	-	24,529
Consumer	1,224	-	-	-	1,224
Total loans	\$580,276	\$28,085	\$ 13,873	\$ -	\$622,234

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. Included in the Current column were \$18,220,000 and \$21,101,000 in unfunded commitments at March 31, 2016 and December 31, 2015, respectively. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of March 31, 2016 and December 31, 2015 (dollars in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90+ Days Past Due	Total Past Due	Current	Total Loans	Non- Accrual
March 31, 2016							
Residential mortgage	\$ 2,431	\$ 361	\$ 797	\$ 3,589	\$281,112	\$284,701	\$ 2,587
Construction, acquisition and development	-	-	-	-	60,053	60,053	286
Land	6	-	6	12	31,598	31,610	267
Lines of credit	-	-	-	-	21,858	21,858	318
Commercial real estate	-	42	423	465	185,805	186,270	2,795
Commercial non-real estate	-	-	-	-	13,156	13,156	-
Home equity	-	241	625	866	22,576	23,442	1,815
Consumer	2	-	206	208	933	1,141	206
Total loans	\$ 2,439	\$ 644	\$ 2,057	\$ 5,140	\$617,091	\$622,231	\$ 8,274
December 31, 2015							
Residential mortgage	\$ 1,593	\$ 65	\$ 2,461	\$ 4,119	\$281,811	\$285,930	\$ 3,191
Construction, acquisition and development	-	-	-	-	77,478	77,478	244
Land	137	-	156	293	28,384	28,677	277
Lines of credit	149	-	-	149	20,039	20,188	483
Commercial real estate	253	-	292	545	174,367	174,912	2,681
Commercial non-real estate	-	-	-	-	9,296	9,296	-
Home equity	-	-	625	625	23,904	24,529	2,098
Consumer	3	-	-	3	1,221	1,224	-
Total loans	\$ 2,135	\$ 65	\$ 3,534	\$ 5,734	\$616,500	\$622,234	\$ 8,974

Bancorp does not have any greater than 90 days and still accruing loans as of March 31, 2016 and December 31, 2015.

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

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

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

Bancorp has not purchased, sold or reclassified any loans to held for sale during the periods discussed. Only loans originated specifically for sale are recorded as held for sale at March 31, 2016 and December 31, 2015.

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

There were 77 restructured loans at March 31, 2016 totaling \$25,261,000, of which 71 loans totaling \$23,934,000 were performing as agreed. Of those performing loans, 58 loans totaling \$20,045,000 have not been late on a payment during the last 2 years.

There were 77 restructured loans at December 31, 2015 totaling \$25,715,000, of which 71 loans totaling \$24,386,000 were performing as agreed.

In the first quarter of 2016 and 2015 there were no TDR’s that subsequently defaulted during the 12 month period ended March 31, 2016 and 2015.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following table presents loans that were restructured during the three months ended March 31, 2016 (dollars in thousands):

	Three months ended March 31, 2016					
	Rate Modification	Contracts Modification	Combination Modifications	Contracts	Total	Total Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	-	-	\$ 624	3	\$ 624	3
Construction, acquisition and development	-	-	-	-	-	-
Land	-	-	-	-	-	-
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	-	-	\$ 624	3	\$ 624	3
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	-	-	\$ 624	3	\$ 624	3
Construction, acquisition and development	-	-	-	-	-	-
Land	-	-	-	-	-	-
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	-	-	\$ 624	3	\$ 624	3

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

The following table presents restructured loans that occurred during the three months ended March 31, 2015 (dollars in thousands):

	Three months ended March 31, 2015					
	Rate Modification	Contracts Modifications	Combination Modifications	Contracts	Total	Total Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	-	-	\$ 91	1	\$ 91	1
Construction, acquisition and development	-	-	-	-	-	-
Land	-	-	-	-	-	-
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	-	-	\$ 91	1	\$ 91	1
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	-	-	\$ 91	1	\$ 91	1
Construction, acquisition and development	-	-	-	-	-	-
Land	-	-	-	-	-	-
Lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial non-real estate	-	-	-	-	-	-
Home equity	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	-	-	\$ 91	1	\$ 91	1

In addition, the TDR is evaluated for impairment. A determination is made as to whether an impaired TDR is cash flow or collateral dependent. If the TDR is cash flow dependent, an allowance for loan losses specific reserve is calculated based on the difference in net present value of future cash flows between the original and modified loan terms. If the TDR is collateral dependent, the collateral securing the TDR, which is always real estate, is evaluated for impairment based on either an appraisal or broker price opinion. If a TDR's collateral valuation is less than its current loan balance, the TDR is written down for accounting purposes by the amount of the difference between the current loan balance and the collateral value. If the borrower performs under the terms of the modification, generally six consecutive months, and the ultimate collectability of all amounts contractually due under the modified terms is not in doubt, the loan is returned to accrual status. There are no loans that have been modified due to the financial difficulties of the borrower that are not considered a TDR. There were no TDR defaults during the quarters ended March 31, 2016 and 2015.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 10 - Loans Receivable - Continued

Interest on TDRs was accounted for under the following methods as of March 31, 2016 and December 31, 2015 (dollars in thousands):

	Number of Contracts	Accrual Status	Number of Contracts	Non- Accrual Status	Total Number of Contracts	Total Modifications
March 31, 2016						
Residential mortgage	55	\$20,416	3	\$ 1,070	58	\$ 21,486
Construction, acquisition and development	1	70	-	-	1	70
Land	6	891	1	6	7	897
Lines of credit	-	-	-	-	-	-
Commercial real estate	4	2,448	2	251	6	2,699
Commercial non-real estate	4	99	-	-	4	99
Home equity	-	-	-	-	-	-
Consumer	1	10	-	-	1	10
Total loans	71	\$23,934	6	\$ 1,327	77	\$ 25,261
December 31, 2015						
Residential mortgage	55	\$20,831	3	\$ 1,071	58	\$ 21,902
Construction, acquisition and development	1	71	-	-	1	71
Land	6	907	1	6	7	913
Lines of credit	-	-	-	-	-	-
Commercial real estate	4	2,464	2	252	6	2,716
Commercial non-real estate	4	103	-	-	4	103
Home equity	-	-	-	-	-	-
Consumer	1	10	-	-	1	10
Total loans	71	\$24,386	6	\$ 1,329	77	\$ 25,715

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

Financial Instruments Whose Contract	Contract Amount At	
Amounts Represent Credit Risk	March 31, 2016	December 31, 2015
Standby letters of credit	\$ 6,169	\$ 5,937
Home equity lines of credit	7,564	7,467
Unadvanced construction commitments	18,220	21,101
Mortgage loan commitments	4,700	3,233
Lines of credit	19,111	27,189
Loans sold with limited repurchase provisions	43,969	65,107

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Standby letters of credit are conditional commitments issued by the Bank guaranteeing performance by a customer to various municipalities. These guarantees are issued primarily to support performance arrangements, limited to real estate transactions. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of March 31, 2016 and December 31, 2015 for guarantees under standby letters of credit issued was \$115,000 for each period.

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

Unadvanced construction commitments are loan commitments made to borrowers for both residential and commercial projects that are either in process or are expected to begin construction shortly.

Mortgage loan commitments not reflected in the accompanying statements of financial condition at March 31, 2016 included seven totaling \$4,700,000 at a fixed range of 3.875% to 4.50% and none at floating interest rates and at December 31, 2015 include seven loans at a fixed interest rate range of 3.75% to 8.00% totaling \$3,233,000 and none at floating interest rates.

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

The Bank has entered into several agreements to sell mortgage loans to third parties. The loans sold under these agreements for the three month period ended March 31, 2016 and year ended December 31, 2015 were \$35,888,000 and \$157,309,000, respectively. These agreements contain limited provisions that require the Bank to repurchase a loan if the loan becomes delinquent within the terms specified by the agreement. The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers.

Only loans originated specifically for sale are recorded as held for sale at the period ended March 31, 2016 and December 31, 2015.

No amount was recognized in the consolidated statement of financial condition at March 31, 2016 and December 31, 2015 as a liability for credit loss related to these loans.

Except for the liability recorded for standby letters of credit of \$115,000 at March 31, 2016 and December 31, 2015, liabilities for credit losses associated with these commitments were not material.

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments

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

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

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

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

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

The following information should not be interpreted as an estimate of the fair value of Bancorp since a fair value calculation is only provided for a limited portion of Bancorp's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between Bancorp's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of Bancorp's financial instruments at March 31, 2016 and December 31, 2015.

Impaired Loans:

Impaired loans are carried at the lower of cost or the present value of expected future cash flows of the loan. If it is determined that the repayment of the loan will be provided solely by the underlying collateral, and there are no other available and reliable sources of repayment, the loan is considered collateral dependent. Impaired loans that are considered collateral dependent are carried at the lower of cost or the fair value of the underlying collateral. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The use of independent appraisals and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and impaired loans are therefore classified within level 3 of the fair value hierarchy.

For such loans that are classified as impaired, an allowance is established when the present value of the expected future cash flows of the impaired loan is lower than the carrying value of that loan. For such loans that are classified as collateral dependent impaired loans, an allowance is established when the current market value of the underlying collateral less its estimated disposal costs has not been finalized, but management determines that it is likely that the value is lower than the carrying value of that loan. Once the net collateral value has been determined, a charge-off is taken for the difference between the net collateral value and the carrying value of the loan.

Impaired loans are those for which Bancorp has measured impairment based on the present value of expected future cash flows or on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consisted of the loan balances of \$14,450,000 and \$16,166,000 at March 31, 2016 and December 31,

2015, respectively, less their valuation allowance of \$2,084,000 and \$2,282,000, respectively. The fair value of two impaired collateral dependent loans that were partially charged off at March 31, 2016 totaled \$403,000 net of charge-offs of \$63,000. The fair value of seven impaired collateral dependent loans that were partially charged off during the year ended December 31, 2015 totaled \$3,219,000 net of charge-offs of \$622,000.

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments - Continued

Foreclosed Real Estate:

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

Foreclosed real estate totaled \$1,737,000 and \$1,744,000 as of March 31, 2016 and December 31, 2015, respectively. The carrying value of foreclosed residential real estate included within foreclosed real estate totaled \$1,261,000 and \$543,000 as of March 31, 2016 and December 31, 2015, respectively.

Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process according to local requirements of the applicable jurisdiction totaled \$2,743,000 as of March 31, 2016.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 11 - Fair Values of Financial Instruments - Continued

The following table sets forth financial assets that were accounted for at fair value on a nonrecurring and recurring basis by level within the fair value hierarchy as of March, 31, 2016 and December 31, 2015:

	March 31, 2016	March 31, 2016 Fair Value Measurement Using: Quoted Prices in Active Markets For Significant Identical Assets (Level 1) (dollars in thousands)			Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>Nonrecurring fair value measurements</u>						
Impaired loans	\$ 12,769	\$ -	\$ -			\$ 12,769
Foreclosed real estate	998	-	-			998
Total nonrecurring fair value measurements	\$ 13,767	\$ -	\$ -			\$ 13,767
<u>Recurring fair value measurements</u>						
Mortgage servicing rights	\$ 550	\$ -	\$ -			\$ 550
Rate lock commitments	\$ 256	\$ -	\$ 256			\$ -
Mandatory forward contracts	\$ (4)	\$ -	\$ (4)			\$ -
Total recurring fair value measurements	\$ 802	\$ -	\$ 252			\$ 550
	December 31, 2015	December 31, 2015 Fair Value Measurement Using: Quoted Prices in Active Markets For Significant Identical Assets (Level 1) (dollars in thousands)			Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>Nonrecurring fair value measurements</u>						
Impaired loans	\$ 17,103	\$ -	\$ -			\$ 17,103
Foreclosed real estate	543	-	-			543
Total nonrecurring fair value measurements	\$ 17,646	\$ -	\$ -			\$ 17,646
<u>Recurring fair value measurements</u>						

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Mortgage servicing rights	\$ 623	\$ -		\$ 623
Rate lock commitments	\$ 141	\$ -	\$ 141	\$ -
Mandatory forward contracts	\$ 111	\$ -	\$ 111	\$ -
Total recurring fair value measurements	\$ 875	\$ -	\$ 252	\$ 623

There were no liabilities that were required to be re-measured on a nonrecurring basis at March 31, 2016 or December 31, 2015.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 11 - Fair Values of Financial Instruments - Continued

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

Quantitative Information about Level 3 Fair Value Measurements			
	Fair Value	Unobservable Input	Range (Weighted Average)
	Valuation Estimate	Techniques	

March 31, 2016

Mortgage servicing rights	\$550	Market approach	Weighted average prepayment speed	9.62%
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December 31, 2015

Mortgage servicing rights	\$623	Market approach	Weighted average prepayment speed	9.91%
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All appraisals are reviewed by the credit department; however, no modifications or adjustments are made to the appraisals received.

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

Quantitative Information about Level 3 Fair Value Measurements			
	Fair Value	Unobservable Input	Range (Weighted Average)
	Valuation Estimate	Techniques	

March 31, 2016

Impaired loans	\$10,797	PV of future cash flows (1)	Discount rate	-6.00%
	\$1,972	Appraisal of collateral (2)	Liquidation expenses (3)	-6.00%
Foreclosed real estate	\$998	Appraisal of collateral (2),(4)	Appraisal adjustments (3)	-100% to -6.02% (-12.79%)

December 31, 2015

Impaired loans	\$13,884	PV of future cash flows (1)	Discount rate	-6.00%
	\$3,219	Appraisal of collateral (2)	Liquidation expenses (3)	-6.00%
Foreclosed real estate	\$543	Appraisal of collateral (2),(4)	Appraisal adjustments (3)	-6.12% to -7.31% (-6.24%)

(1) Cash flow which generally includes various level 3 inputs which are not identifiable.

(2) Fair value is generally determined through independent appraisals for the underlying collateral, which generally include various level 3 inputs which are not identifiable.

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

(4) Includes qualitative adjustments by management and estimated liquidation expenses.

Table of ContentsSEVERN BANCORP, INC. AND SUBSIDIARIESAnnapolis, MarylandNOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUEDNote 11 - Fair Values of Financial Instruments – Continued

The estimated fair values of Bancorp's financial instruments as of March 31, 2016 and December 31, 2015 were as follows:

			Fair Value Measurement at March 31, 2016		
			Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Carrying Amount	Fair Value	(dollars in thousands)		
<u>Financial Assets</u>					
Cash and cash equivalents	\$53,098	\$53,098	\$53,098	\$ -	\$ -
Investment securities (HTM)	74,757	75,856	-	75,856	-
Loans held for sale	5,724	5,786	-	5,786	-
Loans receivable, net	592,655	599,078	-	-	599,078
FHLB stock	5,613	5,613	-	5,613	-
Accrued interest receivable	2,238	2,238	-	2,238	-
Mortgage servicing rights	550	550	-	-	550
Rate lock commitments	256	256	-	256	-
<u>Financial Liabilities</u>					
Deposits	\$524,733	\$525,475	-	525,475	-
FHLB advances	115,000	110,726	-	110,726	-
Subordinated debentures	24,119	24,119	-	-	24,119
Accrued interest payable	3,444	3,444	-	3,444	-
Mandatory forward contracts	4	4	-	4	-
<u>Off Balance Sheet Commitments</u>	\$-	\$-	\$-	\$ -	\$ -

			Fair Value Measurement At December 31, 2015		
	Carrying Amount	Fair Value	Quoted Prices in Active Markets For Identical Assets	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

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			(Level 1)		
			(dollars in thousands)		
<u>Financial Assets</u>					
Cash and cash equivalents	\$43,591	\$43,591	\$43,591	\$ -	\$ -
Investment securities (HTM)	76,133	76,310	-	76,310	-
Loans held for sale	13,203	13,295	-	13,295	-
Loans receivable, net	589,656	593,742	-	-	593,742
FHLB stock	5,626	5,626	-	5,626	-
Accrued interest receivable	2,218	2,218	-	2,218	-
Mortgage servicing rights	623	623	-	-	623
Rate lock commitments	141	141	-	141	-
Mandatory forward contracts	111	111	-	111	-
<u>Financial Liabilities</u>					
Deposits	\$523,771	\$524,458	-	524,458	-
FHLB advances	115,000	110,759	-	110,759	-
Subordinated debentures	24,119	24,119	-	-	24,119
Accrued interest payable	3,137	3,137	-	3,137	-
<u>Off Balance Sheet Commitments</u>	\$-	\$-	\$-	\$ -	\$ -

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

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

Cash and cash equivalents:

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

Investment Securities:

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

Loans held for sale:

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

Loans receivable:

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

FHLB stock:

The carrying amount of FHLB stock approximates fair value based on the redemption provisions of the FHLB. There have been no identified events or changes in circumstances that may have a significant adverse effect on the FHLB stock. Based on our evaluation, we have concluded that our FHLB stock was not impaired at March 31, 2016 and December 31, 2015.

Accrued interest receivable and payable:

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

Derivative Instruments:

Mortgage banking derivatives used in the ordinary course of business primarily consist of mandatory forward sales contracts ("forward contract") and rate lock commitments. The fair value of Bancorp's derivative instruments is primarily measured by obtaining pricing from broker-dealers recognized to be market participants. The pricing is derived from market observable inputs that can generally be verified and do not typically involve significant judgment by Bancorp. Forward contracts and rate lock loan commitments are classified as Level 2 in the fair value hierarchy.

Mortgage servicing rights:

The fair value of mortgage servicing rights is determined using a valuation model administered by a third party that calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service (including delinquency and foreclosure costs), escrow account earnings, contractual servicing fee income and other ancillary income such as late fees. Management reviews all significant assumptions on a monthly basis. Mortgage loan prepayment speed, a key assumption in the model, is the annual rate at which borrowers are forecasted to repay their mortgage loan principal. The discount rate used to determine the present value

of estimated future net servicing income, another key assumption in the model, is an estimate of the required rate of return investors in the market would require for an asset with similar risk. Both assumptions can, and generally will, change as market conditions and interest rates change.

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

Deposit liabilities:

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

FHLB advances:

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

Subordinated debentures:

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

Off-balance sheet financial instruments:

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

Note 12 - Recent Accounting Pronouncements

Under ASU 2014-09, Revenue from Contracts with Customers, establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance. The revenue standard's core principal is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. The new standard applies to all public entities for annual periods beginning after December 15, 2017. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year. Bancorp has evaluated the effect of ASU 2014-09 and believes adoption will not have a material effect on the Consolidated Financial Statements.

Under ASU 2016-01, Amendment to the Recognition and Measurement Guidance for Financial Instruments, an entity is required to: (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in Other Comprehensive Income the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price and; (v) assess a valuation allowance on deferred tax assets related to unrealized losses of Available For Sale debt securities in combination with other deferred tax assets. The Amendment provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. The Amendment also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. The new standard takes effect in 2018 for public companies. Early adoption is only

permitted for the provision related to instrument-specific credit risk and the fair value disclosure exemption provided to nonpublic entities. Bancorp has evaluated the effect of ASU 2016-01 and believes adoption will not have a material effect on the Consolidated Financial Statements.

Table of Contents

SEVERN BANCORP, INC. AND SUBSIDIARIES

Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 12 - Recent Accounting Pronouncements – Continued

In February 2016, the FASB issued ASU 2016-02, “Leases.” The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact this update will have on its consolidated financial position and results of operations.

ASU 2016-08, Revenue from Contracts with Customers, updates the new revenue standard by clarifying the principal versus agent implementation guidance, but does not change the core principle of the new standard. The updates to the principal versus agent guidance:

- require an entity to determine whether it is a principal or an agent for each distinct good or service (or a distinct bundle of goods or services) to be provided to the customer;
- illustrate how an entity that is a principal might apply the control principle to goods, services, or rights to services, when another party is involved in providing goods or services to a customer;
- clarify that the purpose of certain specific control indicators is to support or assist in the assessment of whether an entity controls a good or service before it is transferred to the customer, provide more specific guidance on how the indicators should be considered, and clarify that their relevance will vary depending on the facts and circumstances; and
- revise existing examples and add two new ones to more clearly depict how the guidance should be applied.

Under ASU 2016-09 Stock Compensation, introduces targeted amendments intended to simplify the accounting for stock compensation. Specifically, the ASU requires all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) to be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. That is, off balance sheet accounting for net operating losses stemming from excess tax benefits would no longer be required and instead such net operating losses would be recognized when they arise. Existing net operating losses that are currently tracked off balance sheet would be recognized, net of a valuation allowance if required, through an adjustment to opening retained earnings in the period of adoption. Entities will no longer need to maintain and track an “APIC pool.” The ASU also requires excess tax benefits to be classified along with other income tax cash flows as an operating activity in the statement of cash flows.

In addition, the ASU elevates the statutory tax withholding threshold to qualify for equity classification up to the maximum statutory tax rates in the applicable jurisdiction(s). The ASU also clarifies that cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity.

The ASU provides an optional accounting policy election (with limited exceptions), to be applied on an entity-wide basis, to either estimate the number of awards that are expected to vest (consistent with existing U.S. GAAP) or account for forfeitures when they occur.

Further, the ASU provides two accounting alternatives to nonpublic entities:

37

Table of Contents

• A nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions.

• A nonpublic entity can make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value.

The amendments are effective for public business entities for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted. Bancorp has evaluated the effect of ASU 2016-09 and believes adoption will not have a material effect on the Consolidated Financial Statements.

Note 13 – Subsequent Events

On April 15, 2016, Bancorp entered into subscription agreements with various purchasers under which it issued a total of 2,015,500 shares of its common stock at a price of \$5.50 per share. The shares were issued in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, and Regulation D of the rules and regulations promulgated thereunder. The offering resulted in gross proceeds of approximately \$11,100,000. Costs related to the issuance of the common stock totaled approximately \$500,000 and were netted against the proceeds. Proceeds from the private placement were used in part to pay all accrued and unpaid interest and dividends on Bancorp's Series B Preferred Stock, partially redeem its Series B Preferred Stock, and for general corporate and working capital purposes.

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

The Company

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

Bank Competition

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

Table of Contents

Forward Looking Statements

In addition to the historical information contained herein, the discussion in this report contains forward-looking statements that involve risks and uncertainties and may be affected by various factors that may cause actual results to differ materially from those in the forward-looking statements. The forward-looking statements contained herein include, but are not limited to, those with respect to the Bank's strategy; management's determination of the amount of the loan loss allowance; the effect of changes in interest rates; changes in deposit insurance premiums; ability to meet obligations; and legal proceedings. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "could," "should," "guidance," "potential," "continue," "project," "forecast," "confident," and similar expressions are typically identify forward-looking statements. Bancorp's operations and actual results could differ significantly from those discussed in the forward-looking statements. Some of the factors that could cause or contribute to such differences include, but are not limited to: changes in general economic conditions and political conditions and by governmental monetary and fiscal policies; changes in the economic conditions of the geographic areas in which Bancorp conducts business; changes in interest rates; a downturn in the real estate markets in which Bancorp conducts business; the high degree of risk exhibited by Bancorp's loan portfolio; environmental liabilities with respect to properties Bancorp has title; changes in federal and state regulation; the effects of the supervisory agreements entered into by each of Bancorp and the Bank; Bancorp's ability to estimate loan losses; competition; breaches in security or interruptions in Bancorp's information systems; Bancorp's ability to timely develop and implement technology; Bancorp's ability to retain its management team; perception of Bancorp in the market place; Bancorp's ability to maintain effective internal controls over financial reporting and disclosure controls and procedures; and terrorist attacks and threat of actual war; and other factors detailed from time to time in Bancorp's filings with the Securities and Exchange Commission (the "SEC"), including "Item 1A. Risk Factors" contained in Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

Critical Accounting Policies

Bancorp's significant accounting policies are set forth in Note 1 of the audited consolidated financial statements for the year ended December 31, 2015 which were included in Bancorp's Annual Report on Form 10-K. Of these significant accounting policies, Bancorp considers its policies regarding the allowance for loan losses, the valuation of foreclosed real estate, the evaluation of other than temporary impairment of investment securities and the valuation of the deferred tax asset to be its most critical accounting policies, given the uncertainty in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio and the material effect that such judgments can have on the results of operations and future taxable income. In addition, changes in economic conditions can have a significant impact on real estate values of underlying collateral affecting the allowance for loan losses and therefore the provision for loan losses and results of operations as well as the valuation of foreclosed real estate. Bancorp has developed policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. Bancorp's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

Overview

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

Bancorp had net income of \$907,000 for the three months ended March 31, 2016, compared to \$865,000 for the three months ended March 31, 2015, primarily due to an increase in non-interest income and a slight decrease in non-interest expenses for the first quarter of 2016. Bancorp has experienced stronger loan demand and lower loan delinquencies from the levels experienced during the recent economic downturn. However, Bancorp continues to experience strong competition from financial institutions for loans and deposits. While the housing market has improved, it is still significantly below levels experienced in prior economic recoveries.

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

Table of Contents

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

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

Results of Operations

Net income increased by \$42,000, or 4.9%, to \$907,000 for the first quarter of 2016, compared to \$865,000 for the first quarter of 2015. Basic and diluted income per share remained constant at \$0.03 for the first quarter of 2016 compared to \$0.03 for the first quarter of 2015.

Net interest income, which is interest earned net of interest expense, decreased by \$424,000, or 7.5%, to \$5,235,000 for the first quarter of 2016, compared to \$5,659,000 for the first quarter of 2015. The primary reason for the decrease in net interest income was an increase in the rate on interest-bearing liabilities and a decrease in yield on interest-bearing assets during the first quarter of 2016, compared to the first quarter of 2015.

Bancorp's loan portfolio is subject to varying degrees of credit risk and an allowance for loan losses is maintained to absorb losses inherent in its loan portfolio. Credit risk includes, but is not limited to, the potential for borrower default and the failure of collateral to be worth what Bancorp determined it was worth at the time of the granting of the loan. Bancorp monitors its loan delinquencies at least monthly. All loans that are delinquent and all loans within the various categories of Bancorp's portfolio as a group are evaluated. Bancorp's Board, with the advice and recommendation of Bancorp's management, estimates an allowance to be set aside for loan losses. Included in determining the calculation are such factors as historical losses for each loan portfolio, current market value of the loan's underlying collateral, inherent risk contained within the portfolio after considering the state of the general economy, economic trends, consideration of particular risks inherent in different kinds of lending and consideration of known information that may affect loan collectability.

The provision for loan losses decreased by \$100,000, or 100.0%, to \$0 for the first quarter of 2016, compared to \$100,000 for the first quarter of 2015. This was primarily due to an improvement in the loan portfolio quality and lower loan delinquencies at March 31, 2016 compared to March 31, 2015.

Total non-interest income increased by \$321,000, or 35.7%, to \$1,221,000 for the first quarter of 2016, compared to \$900,000 for the first quarter of 2015. The primary reason for the increase in non-interest income was an increase in mortgage banking activities and other income. Mortgage banking activities increased \$222,000, or 47.2%, to \$692,000 for the first quarter of 2016, compared to \$470,000 for the first quarter of 2015. This increase in activity was the result of an increase in residential loan originations due to the continued low interest rate environment, and management's decision to sell most of the longer term fixed rate mortgages. Real estate commissions by Hyatt Commercial increased by \$11,000, or 10.3%, to \$118,000 for the first quarter of 2016, compared to \$107,000 for the first quarter of 2015. Real estate management fees increased by \$7,000, or 4.4%, to \$165,000 for the first quarter of 2016, compared to \$158,000 for the first quarter of 2015. Other non-interest income increased \$81,000, or 49.1%, to \$246,000 for the first quarter of 2016, compared to \$165,000 for the first quarter of 2015. The increase is due to a higher level of reimbursements received on commercial appraisals in the first quarter of 2016.

Table of Contents

Total non-interest expenses decreased \$44,000, or 0.8%, to \$5,549,000 for the first quarter of 2016, compared to \$5,593,000 for the first quarter of 2015. The primary reason for the decrease in non-interest expenses was a decrease in compensation and related expenses, FDIC assessments and regulatory expense, and professional fees, partially offset by an increase in other expenses, foreclosed real estate expenses and legal expenses. Compensation and related expenses decreased by \$174,000, or 4.6%, to \$3,636,000 for the first quarter of 2016, compared to \$3,810,000 for the first quarter of 2015. This decrease was primarily due to fewer employees and lower payroll taxes paid during the first quarter of 2016 compared to the first quarter of 2015. Net occupancy costs increased by \$27,000, or 6.4%, to \$452,000 for the first quarter of 2016, compared to \$425,000 for the first quarter of 2015. The primary reason for the increase was higher rental and maintenance expenses. The net expense on foreclosed real estate expense increased by \$110,000, to \$45,000 for the first quarter of 2016 compared to net income of \$65,000 for the first quarter of 2015. This increase was primarily due to a lower gain realized on properties sold during the first quarter of 2016, compared to the first quarter of 2015. Legal fees increased by \$68,000, or 109.7%, to \$130,000 for the first quarter of 2016, compared to \$62,000 for the first quarter of 2015. This increase was primarily due to a higher level of legal activity during the first quarter of 2016 on certain foreclosures compared to the first quarter of 2015. FDIC assessments and regulatory expense decreased by \$188,000, or 59.1% to \$130,000 for the first quarter of 2016, compared to \$318,000 for the first quarter of 2015. This decrease was primarily due to a lower rate charged by the FDIC due to the termination of the formal agreements with the OC and the FRB. Professional fees decreased by \$94,000, or 35.3%, to \$172,000 for the first quarter of 2016, compared to \$266,000 for the first quarter of 2015. This decrease was primarily due to a decrease in fees incurred for loan reviews and credit administration projects. Advertising decreased \$9,000, or 6.3%, to \$133,000 for the first quarter of 2016, compared to \$142,000 for the first quarter of 2015. The decrease was due to the timing of advertising expenses during the first quarter of 2016, compared to the first quarter of 2015. Online charges increased \$48,000, or 23.0%, to \$257,000 for the first quarter of 2016, compared to \$209,000 for the first quarter of 2015. This increase was primarily due to a general increase in processing charges and additional online products offered to customers. Credit report and appraisal fees decreased \$27,000, or 20.8%, to \$103,000 for the first quarter of 2016, compared to \$130,000 for the first quarter of 2015. This decrease was primarily due to fewer credit reports and appraisals needed for non-performing loans during the first quarter of 2016, compared to the first quarter of 2015. Other non-interest expenses increased by \$195,000, or 65.9%, to \$491,000 for the first quarter of 2016 compared to \$296,000 for the first quarter of 2015. The increase is due to the higher cost of office supplies and an increase in office supplies purchased.

Income Taxes

Income tax expense decreased by \$1,000 to \$0 for the first quarter of 2016 compared to \$1,000 for the first quarter of 2015. The effective tax rate for the first quarter of 2016 was 0.0% compared to 0.1% for the first quarter of 2015. The low effective tax rates for 2016 and 2015 was primarily due to the utilization of Bancorp's Federal and State net operating loss carryforwards during the quarters ended March 31, 2016 and 2015.

Analysis of Financial Condition

Total assets increased \$3,355,000 to \$765,434,000 at March 31, 2016, compared to \$762,079,000 at December 31, 2015. Cash and cash equivalents increased by \$9,507,000, or 21.8%, to \$53,098,000 at March 31, 2016, compared to \$43,591,000 at December 31, 2015. This increase was primarily due to a higher level of proceeds received on loans held for sale and management's decision to increase cash balances to preserve liquidity at March 31, 2016, compared to December 31, 2015. Net loans receivable increased \$2,999,000, or 0.5%, to \$592,655,000 at March 31, 2016, compared to \$589,656,000 at December 31, 2015. This increase was due to an increase in demand for loans during the first quarter of 2016. Loans held for sale decreased \$7,479,000, or 56.6%, to \$5,724,000 at March 31, 2016, compared to \$13,203,000 at December 31, 2015. This decrease was primarily due to the timing of loans pending sale as of March 31, 2016. Foreclosed real estate decreased \$7,000, or 0.4%, to \$1,737,000 at March 31, 2016 compared to \$1,744,000 at December 31, 2015. Total deposits increased \$962,000, or 0.2%, to \$524,733,000 at March 31, 2016 compared to \$523,771,000 at December 31, 2015. Long-term borrowings remained at \$115,000,000 at March 31,

2016 and December 31, 2015. These borrowings will begin to mature in August, 2016.

Stockholders' Equity

Total stockholders' equity increased \$429,000 to \$86,885,000 at March 31, 2016 compared to \$86,456,000 as of December 31, 2015. This increase was primarily a result of net income for the first three months of 2016 partially offset by the dividends declared on Bancorp's Series B preferred stock.

Table of Contents

Liquidity

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

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

Management believes Bancorp has sufficient cash flow and liquidity to meet its current commitments through the next 12 months. Certificates of deposit, which are scheduled to mature in less than one year, totaled \$154,226,000 at March 31, 2016. Based on past experience, management believes that a significant portion of such deposits will remain with Bancorp. At March 31, 2016, Bancorp had commitments to originate mortgage loans of \$4,700,000, unadvanced home equity lines of credit of \$7,564,000, unadvanced construction commitments of \$18,220,000, unused lines of credit of \$19,111,000 and commitments under standby letters of credit of \$6,169,000. Bancorp has the ability to reduce its commitments for new loan originations, adjust other cash outflows, and borrow from FHLB Atlanta should the need arise. As of March 31, 2016, outstanding FHLB Atlanta borrowings totaled \$115,000,000, and Bancorp had available to it an additional \$74,690,000 in borrowing availability from FHLB Atlanta.

Net cash provided by operating activities increased \$11,672,000 to \$10,028,000 for the three months ended March 31, 2016, compared to net cash used in operating activities of \$1,644,000 for the same period in 2015. This increase was primarily the result of an increase in proceeds from loans sold in 2016. Net cash used in investing activities decreased \$18,622,000 to \$1,483,000 for the three months ended March 31, 2016, compared to cash provided by investing activities of \$17,139,000 for the same period in 2015. This increase was primarily due to loans increasing in the first quarter of 2016 compared to decreasing in the first quarter of 2015. Net cash provided by financing activities decreased \$1,852,000 to \$962,000 for the three months ended March 31, 2016, compared to \$2,814,000 for the same period in 2015. This decrease was primarily due to a net increase in deposits in 2016 that was lower than the net increase in deposits during the same period in 2015.

Federal Home Loan Bank of Atlanta Line of Credit

The Bank's credit availability at the FHLB is based on the level of collateral pledged up to 25% of total assets. As of March 31, 2016, the total available line of credit with the FHLB Atlanta was approximately \$189,690,000, of which \$115,000,000 was outstanding in the form of long-term borrowings. The Bank, from time to time, utilizes the line of credit when interest rates are more favorable than obtaining deposits from the public.

The following table sets forth information concerning the interest rates and maturity dates of the advances from the FHLB Atlanta as of March 31, 2016 (dollars in thousands):

Principal Amount	Rate	Maturity
\$ 15,000	1.81% to 1.83%	2016
70,000	2.43% to 4.05%	2017
15,000	2.58% to 3.43%	2018
15,000	4.00%	2019
\$ 115,000		

Table of Contents

Subordinated Debentures

As of March 31, 2016, Bancorp had outstanding \$20,619,000 principal amount of Junior Subordinated Debt Securities Due 2035 (the “2035 Debentures”). The 2035 Debentures were issued pursuant to an Indenture dated as of December 17, 2004 (the “2035 Indenture”) between Bancorp and Wells Fargo Bank, National Association, as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of LIBOR (0.622% as of March 31, 2016) plus 200 basis points, and mature on January 7, 2035. Payments of principal, interest, premium and other amounts under the 2035 Debentures are subordinated and junior in right of payment to the prior payment in full of all senior indebtedness of Bancorp, as defined in the 2035 Indenture. The 2035 Debentures became redeemable, in whole or in part, by Bancorp on January 7, 2010.

The 2035 Debentures were issued and sold to Severn Capital Trust I (the “Trust”), of which 100% of the common equity is owned by Bancorp. The Trust was formed for the purpose of issuing corporation-obligated mandatorily redeemable Capital Securities (“Capital Securities”) to third-party investors and using the proceeds from the sale of such Capital Securities to purchase the 2035 Debentures. The 2035 Debentures held by the Trust are the sole assets of the Trust. Distributions on the Capital Securities issued by the Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Trust on the 2035 Debentures. The Capital Securities are subject to mandatory redemption, in whole or in part, upon repayment of the 2035 Debentures. Bancorp has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee. Under the terms of the 2035 Indenture, Bancorp is permitted to defer the payment of interest on the 2035 Debentures for up to 20 consecutive quarterly periods provided that no event of default has occurred and is continuing. As of March 31, 2016, Bancorp has deferred the payment of sixteen quarters of interest and the cumulative amount of interest in arrears not paid, including interest on unpaid interest, was \$2,011,000. Bancorp paid all interest in arrears subsequent to March 31, 2016.

Under the terms of Bancorp’s 2035 Indenture, if Bancorp has deferred payments of interest on the 2035 Debentures, the Bancorp may not, among other things, declare or pay any dividends or distributions on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of its capital stock, including common stock until all such deferred interest has been paid. Accordingly, Bancorp will not be able to pay dividends on its common stock until the deferred interest on the 2035 Debentures has been paid in full.

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

The aggregate principal amount of Subordinated Notes outstanding at March 31, 2016 was \$3,500,000. The Subordinated Notes earn interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31, 2018. Debt issuance costs totaled \$245,000 and are being amortized over 10 years. Interest payments on the Subordinated Notes are current as of March 31, 2016.

Common Stock

On April 14, 2016, Bancorp entered into subscription agreements with various purchasers under which it would issue a total of 2,015,500 shares of its common stock at a price of \$5.50 per share. The shares were issued in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, and Regulation D of the rules and regulations promulgated thereunder. The offering resulted in gross proceeds of approximately \$11,100,000. Costs related to the issuance of the common stock totaled approximately \$500,000 and were netted

against the proceeds.

43

Table of Contents

Preferred Stock

Bancorp issued a total of 437,500 shares of its Series A 8.0% Non-Cumulative Convertible Preferred Stock ("Series A Preferred Stock") as part of the private placement offering completed on November 15, 2008. The liquidation preference is \$8.00 per share. Each share of Series A Preferred Stock is convertible at the option of the holder into one share of Bancorp's common stock, subject to adjustment upon certain corporate events. The initial conversion rate is equivalent to an initial conversion price of \$8.00 per share of Bancorp's common stock. At the option of Bancorp, on and after December 31, 2014, at any time and from time to time, some or all of the Series A Preferred Stock may be converted into shares of Bancorp's common stock at the then-applicable conversion rate. Costs related to the issuance of the preferred stock totaled \$247,000 and were netted against the proceeds.

If declared by Bancorp's board of directors, cash dividends at an annual rate of 8.0% will be paid quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. Dividends will not be paid on Bancorp's common stock in any quarter until the dividend on the Series A Preferred Stock has been paid for such quarter; however, there is no requirement that Bancorp's board of directors declare any dividends on the Series A Preferred Stock and any unpaid dividends shall not be cumulative. Dividends on the Series A Preferred Stock have not been declared since the first quarter of 2012.

On November 21, 2008, Bancorp entered into an agreement with the United States Department of the Treasury ("Treasury"), pursuant to which Bancorp issued and sold (i) 23,393 shares of its Series B Fixed Rate Cumulative Perpetual Preferred Stock, par value \$0.01 per share and liquidation preference \$1,000 per share, (the "Series B Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 556,976 shares of Bancorp's common stock, par value \$0.01 per share, for an aggregate purchase price of \$23,393,000. Costs related to the issuance of the preferred stock and warrants totaled \$45,000 and were netted against the proceeds. On September 25, 2013, the Treasury sold all of its 23,393 shares of Series B Preferred Stock to outside investors as part of their ongoing efforts to wind down and recover its remaining investments under the Troubled Asset Relief Program ("TARP"). The terms of the Series B Preferred Stock remain the same. The Treasury continues to hold a warrant to purchase 556,976 shares of Bancorp's common stock.

The Series B Preferred Stock qualifies as Tier 1 capital and pays cumulative compounding dividends at a rate of 5% per annum for the first five years, and 9% per annum effective November 21, 2013. The Series B Preferred Stock may be redeemed by Bancorp.

The Series B Preferred Stock has no maturity date and ranks pari passu with Bancorp's existing Series A Preferred Stock, in terms of dividend payments and distributions upon liquidation, dissolution and winding up of Bancorp.

The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, Bancorp's authorized number of directors will be automatically increased by two and the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, will have the right to elect those directors at Bancorp's next annual meeting of stockholders or at a special meeting of stockholders called for that purpose. These preferred share directors will be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid. In connection with the sale by the Treasury of the Series B Preferred Stock, the Federal Reserve obtained waivers from the outside investors who purchased the Series B Preferred Stock in which such investors agreed not to exercise their right to elect directors, and certain other voting or control rights, without the prior approval of the Federal Reserve.

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

Common Stock issued upon exercise of the Warrant.

44

Table of Contents

Bancorp's ability to declare dividends on its common stock are limited by the terms of Bancorp's Series A preferred stock and Series B preferred stock. Bancorp may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to its common stock in any quarter until the dividend on the Series A Preferred Stock has been declared and paid for such quarter, subject to certain minor exceptions. Additionally Bancorp may not declare or pay any dividend or distribution on its common stock, and Bancorp may not purchase, redeem or otherwise acquire for consideration any of its common stock, unless all accrued and unpaid dividends for all past dividend periods, including the latest completed dividend period, on all outstanding shares of Series B Preferred Stock have been or are contemporaneously declared and paid in full (or have been declared and a sum sufficient for the payment thereof has been set aside), subject to certain minor exceptions.

As of March 31, 2016, dividends on the Series A Preferred Stock and Series B Preferred Stock had not been paid since the first quarter of 2012. As of March 31, 2016, Bancorp had unpaid cumulative dividends and interest in arrears on the Series B Preferred Stock of \$7,951,000. Bancorp paid all dividends and interest in arrears on the Series B Preferred Stock subsequent to March 31, 2016.

Effects of Inflation

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

Average Balance Sheet

The following table presents Bancorp's distribution of the average consolidated balance sheets and net interest analysis for the three months ended March 31, 2016 and March 31, 2015:

Table of Contents

	Three Months Ended March 31, 2016				Three Months Ended March 31, 2015			
	Average Volume	Interest	Yield/Cost		Average Volume	Interest	Yield/Cost	
	(dollars in thousands)							
ASSETS								
Loans (1)	\$ 596,639	\$ 7,107	4.76	%	\$ 636,172	\$ 7,546	4.74	%
Held to maturity securities (2)	75,218	311	1.65	%	58,882	233	1.58	%
Other interest-earning assets (3)	10,779	86	3.19	%	7,450	81	4.33	%
Total interest-earning assets	682,636	7,504	4.40	%	702,504	7,860	4.48	%
Non-interest earning assets	78,996				69,334			
Total assets	\$ 761,632				\$ 771,838			
LIABILITIES AND STOCKHOLDERS' EQUITY								
Savings and checking deposits	\$ 245,354	155	0.25	%	\$ 242,544	164	0.27	%
Certificates of deposit	278,290	824	1.18	%	296,239	840	1.13	%
Borrowings	139,119	1,290	3.71	%	139,119	1,197	3.44	%
Total interest-bearing liabilities	662,763	2,269	1.37	%	677,902	2,201	1.30	%
Non-interest bearing liabilities	13,931				11,436			
Stockholders' equity	84,938				82,500			
Total liabilities and stockholders' equity	\$ 761,632				\$ 771,838			
Net interest income and interest rate spread		\$ 5,235	3.03	%		\$ 5,659	3.18	%
Net interest margin			3.07	%			3.22	%
Average interest-earning assets to average interest-bearing liabilities			103.00	%			103.63	%

(1) Loans held for sale and non-accrual loans are included in the average balances and in the computation of yields.

(2) Bancorp does not have any tax-exempt securities.

(3) Other interest-earning assets include interest-bearing deposits in other banks, federal funds sold and FHLB stock investments.

Table of Contents

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Under the supervision and with the participation of Bancorp's management, including its Chief Executive Officer and Chief Financial Officer, Bancorp has evaluated the effectiveness of its disclosure controls and procedures as of March 31, 2016. Disclosure controls and procedures are defined in Rule 13a-15(e) under the Securities Exchange Act as those controls and other procedures of an issuer that are designed to ensure that the information required to be disclosed by the issuer in the reports it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the period covered by this report, Bancorp's disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

Bancorp's management, with the participation of its Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of Bancorp's internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f), to determine whether any changes occurred during the quarter ended March 31, 2016, that have materially affected, or are reasonably likely to materially affect, Bancorp's internal control over financial reporting. Based on that evaluation, there were no such changes during the quarter ended March 31, 2016.

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

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Table of Contents

Item 1A. Risk Factors

The risk factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 should be carefully considered by you. If any of the risks actually occur, Bancorp’s business, financial condition or results of operations could be materially and adversely affected. The risks described in our Annual Report on Form 10-K are not the only risks facing Bancorp. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or results of operations. This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Bancorp’s actual results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by Bancorp described in Bancorp’s Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

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

As previously reported, on April 15, 2016, Bancorp entered into subscription agreements with various purchasers under which it issued a total of 2,015,500 shares of its common stock at a price of \$5.50 per share. The shares were issued in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, and Regulation D of the rules and regulations promulgated thereunder. The offering resulted in gross proceeds of approximately \$11,100,000. Costs related to the issuance of the common stock totaled approximately \$500,000 and were netted against the proceeds. Proceeds from the private placement were used in part to pay all accrued and unpaid interest and dividends on Bancorp’s Series B Preferred Stock, partially redeem its Series B Preferred Stock, and for general corporate and working capital purposes.

Item 3. Defaults Upon Senior Securities

As noted above, dividends on the Series A Preferred Stock and Series B Preferred Stock had not been paid since the first quarter of 2012. As of March 31, 2016, Bancorp had unpaid cumulative dividends and interest in arrears on the Series B Preferred Stock of \$7,951,000. Bancorp paid all dividends and interest in arrears on the Series B Preferred Stock subsequent to March 31, 2016.

Also as noted above, as permitted under the terms of the 2035 Indenture, as of March 31, 2016, Bancorp has deferred the payment of sixteen quarters of interest on its 2035 Debentures and the cumulative amount of interest in arrears not paid, including interest on unpaid interest, was \$2,011,000. Bancorp paid all interest in arrears subsequent to March 31, 2016.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

<u>Exhibit</u> <u>No.</u>	<u>Description</u>
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31.1	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
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31.2 Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 The following financial statements from the Severn Bancorp, Inc. Quarterly Report on Form 10-Q as of March 31, 2016 and for the three months ended March 31, 2016, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Statements of Financial Condition; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Stockholders' Equity; (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to Consolidated Financial Statements.

Table of Contents

SIGNATURES

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

SEVERN BANCORP, INC.

May 12, 2016 Alan J. Hyatt
Alan J. Hyatt, Chairman of the Board,
President and Chief Executive Officer
(Principal Executive Officer)

May 12, 2016 Thomas G. Bevivino
Thomas G. Bevivino,
Executive Vice President, Chief Financial
Officer
(Principal Financial and Accounting Officer)

Table of Contents

Exhibit Index

Exhibit
No. Description

<u>31.1</u>	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002
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