HARBOR BANKSHARES CORP
Form 10KSB
March 24, 2004
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number : 0-20990

HARBOR BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland **(State or other jurisdiction of incorporation or organization)**	**52-1786341** **(IRS Employer Identification No.)**
25 West Fayette Street	
Baltimore, Maryland **(Address of principal executive officer)**	**21201** **(Zip Code)**

Registrant s telephone number, including area code: (410) 528-1800

Securities registered pursuant to Section 12(b) of the Act: None.

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

Common Stock, par value $0.01 per share

(Title of Class)

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

Yes x No ¨

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

Issuer s revenues for its most recent fiscal year: $ 14,392,435

As of March 5, 2004, the registrant had 704,176 shares of Common Stock issued and outstanding, including 33,795 non-voting shares. The aggregate market value of shares held by nonaffiliates on such date was $7,603,578 based on the average of the bid and asked price of $20.00 per share of the Registrant s Common Stock on that date. For purposes of this calculation, it is assumed that the 424,998 shares held by directors and executive officers of the Registrant, are shares held by affiliates.

Documents Incorporated by Reference: Portions of the Registrant s Annual Report to Stockholders for the year ended December 31, 2003 and Registrant s 2004 Proxy Statement are incorporated by reference into Parts I and II.

Transitional small business disclosure format (check one): Yes ¨ No x

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Documents Incorporated by Reference

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PART I

Forward Looking Statements

Item 1. Description of Business, Item 3. Legal Proceedings, Item 6. Management s Discussion and Analysis of Financial Condition and Results of Operations, and other portions of this annual report on Form 10-KSB include forward-looking statements such as: statements of Harbor Bancshares Corporation s goals, intentions, and expectations; estimates of risks and of future costs and benefits; assessments of loan quality, probable loan losses, liquidity, off-balance sheet arrangements, and interest rate risk; and statements of its ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates and other economic conditions; future laws, regulations and accounting principles; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, Harbor Bankshares Corporation s past growth and performance do not necessarily indicate its future results.

Item 1. Description of Business

Harbor Bankshares Corporation

Harbor Bankshares Corporation (the Corporation) is a bank holding company with one bank subsidiary and two other Community Development financial subsidiaries, one for profit, The Harbor Bank of Baltimore LLC and a non-profit, The Harbor Bank CDC. Both were established during 2002. The Corporation has no investment in either subsidiary as of December 31, 2003. The Corporation was organized under the laws of the State of Maryland in 1992. On November 2, 1992, Harbor Bankshares Corporation acquired all outstanding stock of The Harbor Bank of Maryland (the Bank), headquartered in Baltimore, Maryland.

The Harbor Bank of Maryland

The Harbor Bank of Maryland is a state chartered institution in the State of Maryland. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation.

The Harbor Bank of Maryland is a commercial bank headquartered in Baltimore, Maryland. The Bank conducts a general commercial and retail business. The Bank was opened on September 13, 1982 and was incorporated under the laws of the State of Maryland. During the second and third quarters of 1994, the Corporation, through its subsidiary, The Harbor Bank of Maryland acquired three (3) branch locations from the

Resolution Trust Corporation; two (2) located in Baltimore City, and one (1) located in Riverdale, Prince George s County. A new branch location was opened during December 1995 in Baltimore County, expanding the market area of the Bank. During May 1997, The Harbor Bank of Maryland opened a *de novo* branch location in the East side of Baltimore City, and on January 19, 1999, a *de novo* branch was opened in the West side of the City, this branch location was closed during March 2002. During September 2000, a branch located in Baltimore City was also closed. The closing of both facilities have helped the profitability of the Bank.

In April, 2002, the Bank purchased a branch location from another financial institution in Baltimore County in order to increase its market share. The purchase included $18.8 million in deposits. The Bank had a location near the purchased facility and both were merged into the acquired office in order to reduce the overhead cost of running both branches.

Harbor Financial Services, a company dealing with the sale of mutual funds, stocks, insurance, etc., was established as a subsidiary of the Bank during May 1997, in order to compete with that expanding market. This subsidiary had a loss of $11 thousand for the year ended December 31, 2003.

The Bank conducts general banking business in six (6) locations and serves primarily the Baltimore Metropolitan area. It offers checking, savings and time deposits, commercial, real estate, personal, home improvement, automobile and other

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installment loans, credit cards and term loans. The Bank is also a member of a local and national ATM network. The retail nature of the Bank allows for full diversification of deposits and borrowers so it is not dependent upon a single or a few customers.

Competition

The Corporation s subsidiary, The Harbor Bank of Maryland, competes with virtually all banks and savings institutions, which offer services in its market area. The Bank directly competes with branches of most of the State s largest banks, each of which has greater financial and other resources to conduct large advertising campaigns and to allocate their investment assets to regions of higher yield and demand. To attract business in this competitive environment, the Bank relies heavily on local promotional activities and personal contact by its officers and directors and by its ability to provide personalized services.

Supervision and Regulation

Harbor Bankshares Corporation is a registered bank holding company subject to regulation and examination by the board of governors of the Federal Reserve System under the Bank Holding Company Act of 1956 (the Act). The Corporation is required to file with the board of governors quarterly and annual reports and any additional information that may be required according to the Act. The Act also requires every bank holding company to obtain the prior approval of the Federal Reserve Board before acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank that is not already majority owned. The Act also prohibits a bank holding company, with certain exceptions, from engaging in or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in non-banking activities. One of the principal exceptions to these provisions is for engaging or acquiring shares of a company engaged in activities found by the Federal Reserve Board to be so closely related to banking or managing banks to be a proper incident thereto.

The Harbor Bank of Maryland is a state chartered institution insured by the Federal Deposit Insurance Corporation (FDIC) and subject to federal and state laws applicable to commercial banks. The Bank is examined regularly by FDIC and the State of Maryland Banking Commissioner s office.

In accordance with Federal Reserve regulation, the Bank is limited as to the amount it may loan affiliates, including the Corporation, unless such loans are collateralized by specific obligations. Additionally, banking law limits the amount of dividends that a bank can pay without prior approval from bank regulators.

Governmental Monetary Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of The Harbor Bank of Maryland, Harbor Bankshares Corporation s sole subsidiary, are affected by the credit policies of monetary authorities including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market operations in U.S. Government securities, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans and investments and deposits, and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future.

In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the Federal Reserve System, no prediction can be made as to possible future changes in interest rates, deposit levels, and loan demand, or their effect on the business and earnings of the Corporation and its subsidiary.

Employees

At December 31, 2003, Harbor Bankshares Corporation and its subsidiaries employed 78 individuals, of which 27 were officers and 51 were full-time employees.

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Executive Officers

Information concerning executive officers of the Corporation is listed below:

Executive Officers	**Age**	**Position**
Joseph Haskins, Jr.	56	Chairman, President and Chief Executive Officer of the Bank and Corporation
John Paterakis	75	Chairman of the Executive Committee of the Corporation and the Bank
Teodoro J. Hernandez	58	Treasurer of the Corporation and Senior Vice President and Cashier of the Bank

Tabular Information

Exhibit A, B, C and D to the Registrant s Annual Report to Shareholders for the year ended December 31, 2003 (the Annual Report) are incorporated herein by reference. The information in this description of business should be read in conjunction with the information provided in the Management s Discussion and Analysis of Financial Condition and Operations, which is incorporated herein from the Annual Report.

Investment Securities *(dollars in thousands)*

Maturity Distribution of Investment Securities *(dollars in thousands)*

	U.S. Treasuries	**U.S. Agencies**	**Other Securities**	**TOTAL**
Maturing Within One Year	$ 2,018	$ 11,190	$ 507	$ 13,715
Maturing After One But Within Five Years		21,852		21,852
Maturing After Five But Within Ten Years		1,966		1,966
Maturing After Ten Years		343	42	385
TOTAL	$ 2,018	$ 35,351	$ 549	$ 37,918

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Weighted Average Interest Rates of Investment Securities at December 31, 2003

	U.S. Treasury	U.S. Government Agencies	Other Securities	TOTAL
Maturing Within One Year	3.25%	3.31%	2.87%	3.14%
Maturing After One But Within Five Years		3.57%		3.57%
Maturing After Five But Within Ten Years		3.34%		3.34%
Maturing After Ten Years		6.19%	7.25%	6.35%
TOTAL	3.25%	3.41%	3.35%	3.34%

Carrying amount and the market value of Investment Securities at 2003 , 2002 AND 2001 (*dollars in thousands)*

	2003		2002		2001	
	Amortized Cost	Market	Amortized Cost	Market	Amortized Cost	Market
U.S. Treasuries, Government Agencies and Mortgage Backed Securities	$ 37,258	$ 37,369	$ 54,370	$ 55,254	$ 50,879	$ 50,501
Other Securities	548	549	554	561	558	553
TOTAL	$ 37,806	$ 37,918	$ 54,924	$ 55,815	$ 51,437	$ 51,054

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Loan Distribution

Five-Year Loan Distribution at December 31 *(dollars in thousands)*

	2003	2002	2001	2000	1999
Commercial Loans	$ 55,184	$ 30,964	$ 23,126	$ 33,515	$ 31,801
Real Estate Loans	87,228	78,856	71,962	70,596	67,117
Consumer Loans	8,806	11,751	11,718	8,286	3,583
TOTAL	$ 151,218	$ 121,571	$ 106,806	$ 112,397	$ 102,501

Five-Year Loan Distribution at December 31 *(expressed as percentages)*

	2003	2002	2001	2000	1999
Commercial Loans	36.49%	25.47%	21.65%	29.82%	31.03%
Real Estate Loans	57.69%	64.86%	67.38%	62.80%	65.47%
Consumer Loans	5.82%	9.67%	10.97%	7.38%	3.50%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%

Maturity and Repricing of Loans and December 31, 2003 *(dollars in thousands)*

	Commercial Loans	Real Estate Loans	Consumer Loans	TOTAL
Within One Year	$ 32,734	$ 5,444	$ 1,513	$ 39,691
After One Year But Within Five Years	17,679	27,595	5,521	$ 50,795
After Five Years	4,771	54,189	1,772	$ 60,732
TOTAL	$ 55,184	$ 87,228	$ 8,806	$ 151,218

Loans Classified by Sensitivity to Changes in Interest Rates *(dollars in thousands)*

	Fixed Interest Rate Loans	Adjustable Interest Rate Loans	TOTAL
Within One Year	$ 9,111	$ 38,882	$ 47,993
After One But Within Five Years	50,762	595	51,357
After Five Years	51,868		51,868
TOTAL	$ 111,741	$ 39,477	$ 151,218

Asset Quality

One of the Corporation s main objectives has been and continues to be the achievement of a high level of asset quality. We maintain a large portion of loans secured by residential one-to four- family properties and commercial properties. As of December 31, 2003, those loans totaled $78 million or 51.32 percent of total outstanding loans. We set sound credit standards for new loan originations, and follow careful loan administration procedures. We strengthened our focus on credit risk by having independent reviews of all major credit with detailed reports to management.

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Delinquent Loans and Foreclosed Assets: The Corporation policies require that management continuously monitor the status of the loan portfolio and report to the Board of Directors on a monthly basis. These reports include information on delinquent loans and foreclosed real estate, and actions and plans to cure the delinquent status of the loans and to dispose of the foreclosed properties.

Interest on Non-accrual Loans. *(dollars in thousands)*

	2003	2002
Interest Income that Would Have Been Recorded Under Original Terms	$ 30	$ 57
Interest Income Recorded during the Period	$	$

It is the policy of the Corporation to place a loan on non-accrual status whenever there is substantial doubt about the ability of a borrower to pay principal or interest on any outstanding credit. Management considers such factors as payment history, the nature of the collateral securing the loan, and the overall economic situation of the borrower when making a non-accrual decision. Non-accrual loans are closely monitored by management. A non-accruing loan is restored to accrual status when principal and interest payments have been brought current or it becomes well-secured or is in the process of collection and the prospects of future contractual payments are no longer in doubt.

We generally stop accruing income when interest or principal payments are between 90 and 120 days in arrears. We may stop accruing income on such loans earlier than 90 days when we consider the timely collectibility of interest or principal payment to be doubtful.

When we designate non-accrual loans, we reverse all outstanding interest that we had previously credited. If we receive a payment on a non-accrual loan, we may recognize a portion of that payment as interest income if we determine that the ultimate collectibility of principal is no longer in doubt. However, such loans may remain in non-accrual status.

Impaired Loans

At December 31, 2003, the Corporation had $1,184 thousand of impaired loans for which the borrowers were experiencing financial difficulties. Those loans are subject to constant management attention and their classification is reviewed monthly. Impaired loans are individually assessed to determine whether the carrying value exceeds the fair value of the collateral.

Foreclosed Real Estate

Foreclosed real estate consists of property we have acquired through foreclosed or deed in lieu of foreclosure. Foreclosed real estate properties are initially recorded at the lower of the recorded investment in the loan or fair value. At December 31, 2003, 2002 and 2001, respectively, we had $0, $70 thousand and $14 thousand in foreclosed real estate.

Potential Nonperforming Loans

Those performing loans considered potential nonperforming loans, loans which are not included in the past due, nonaccrual or restructured categories, but for which known information about possible credit problems cause management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms over the next six months, amounted to approximately $3,502 thousand at December 31, 2003, compared to $3,270 thousand at December 31, 2002, and $2,215 thousand at December 31, 2001. These loans are subject to continuing management attention and are considered by management in determining the level of the allowance for loan losses.

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Allowance for Loan Losses

The Corporation s allowance for loan loss methodology is a loan classification-based system, based on the required reserve on a percentage of the loan balance for each type of loan and classification level. Watch, special mention, substandard and doubtful loans are reserved at 5.0%, 10.0%, 20.0% and 50.0%, respectively. Reserve percentages are based on each individual lending program, its loss history and underwriting characteristics including loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss reserve matrix as well as assist in establishing overall lending direction. The $439, thousand, or 41.8%, increase in the allowance in 2003 was primarily the result of substantial loan growth, particularly in categories that have historically higher risk, such as commercial and commercial real estate Loans, and a decline in the percentage of the portfolio represented by historically lower risk residential real estate loans. During 2003, there were no changes in estimation methods or assumptions that affected the methodology for assessing the appropriateness of the allowance.

While management considers the Corporation s allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management s assumptions as to future delinquencies or loss rates, and management s intent with regard to asset disposition options. In addition, the Corporation s allowance for loan losses is periodically reviewed by the bank regulatory agencies as an integral part of their examination process. Based on their review, the agencies may require the Corporation to adjust the allowance.

Maturities of Time Certificates of Deposit of $100,000 or More Outstanding at December 31, 2002 and 2001

(dollars in thousands)

	2003	2002
Three months or less	$ 9,013	$ 7,993
Three to six months	5,678	2,871
Six to twelve months	5,233	10,909
Over twelve months	5,170	4,069
TOTAL	$ 25,094	$ 25,842

Long And Short Term Borrowings

Long term borrowings for the year 2003 and 2002 consist of a note payable due July 1, 2012 at a fixed rate of 7.0% with interest payments only from August 2001 to August 2002 and equal principal and interest payments from August 2002 to July 1, 2012. This note was paid during October, 2003. On October 9, 2003, Harbor Bankshares Corporation issued a Floating Rate Junior Subordinated Debt Securities due 2033 in the amount of $7.2 million. The Debt Security was issued by the corporation pursuant to an Indenture, dated as of October 9, 2003, between the Corporation and Wilmington Trust Company. The Capital Securities will be issued by Harbor Bankshares Corporation Capital Trust pursuant to a Purchase Agreement dated September 18, 2003, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon receipt of the funds, the corporation paid off its long-term debt to N.C.I.F. in the amount of $1.8 million and placed the remaining funds in its subsidiary, The Harbor Bank of Maryland, increasing the Bank s Tier One capital. This capital infusion will allow the Bank to increase its lending limit and allow for future growth.

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Borrowings for the Years Ended December 31, 2003 and 2002

(dollars in thousands)

	2003	2002
Amount outstanding at period-end:		
Long-term debt	$ 0	$ 1,943
Subordinated Debt Securities	7,217	0
Average outstanding:		
Long-term debt	$ 1,310	$ 1,986
Subordinated Debt Securities	1,611	0
Weighted average interest rate during the period:		
Long-term debt	7.00%	7.00%
Subordinated Debt Securities	4.40%	0

Off-Balance Sheet Arrangements

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. County National Bank has not been required to perform on any financial guarantees and has not incurred any losses on its commitments. The issuance of letters of credit is not a significant activity of the Bank.

Commitments to extend credit are agreements to lend funds to customers as long as there are no violations of any condition established in the loan contracts. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer s credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on credit evaluation by management. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment as well as income producing properties. We believe that we have adequate resources to fund all loan commitments.

The Bank has entered into leases for its branch and office space, most of which contain renewal options.

For additional information regarding off-balance sheet arrangements, please see Notes 7 and 20 to the Consolidated Financial Statements and the discussion of the Debt Security in Long and Short Term Borrowings, above.