SEVERN BANCORP INC
Form 10-Q
November 12, 2009

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

FORM 10-Q

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

For the quarterly period ended September 30, 2009

or

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

For the transition period from to .

Commission File Number 0-49731

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<br>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 þ No o

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 file). Yes o No o

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.

Large accelerated filer o Accelerated filer o

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

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

Number of shares of the registrant's Common Stock, $0.01 par value, outstanding as of the close of business on November 12, 2009: 10,066,679 shares.

SEVERN BANCORP, INC. AND SUBSIDIARIES
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PART I– FINANCIAL INFORMATION

Item 1. Financial Statements

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (UNAUDITED)
(dollars in thousands, except per share amounts)

| | September 30, 2009 | December 31, 2008 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ 29,837 | $ 14,082 |
| Interest bearing deposits in other banks | 474 | 271 |
| Federal funds sold | 40,000 | 17,952 |
| Cash and cash equivalents | 70,311 | 32,305 |
| Investment securities held to maturity | 9,229 | 1,345 |
| Loans held for sale | 1,418 | 453 |
| Loans receivable, net of allowance for loan losses of $34,009 and $14,813, respectively | 835,756 | 896,006 |
| Premises and equipment, net | 29,411 | 30,267 |
| Other real estate owned | 17,877 | 6,317 |
| Federal Home Loan Bank of Atlanta stock at cost | 8,609 | 8,694 |
| Accrued interest receivable and other assets | 23,293 | 12,264 |
| Total assets | $ 995,904 | $ 987,651 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities | | |
| Deposits | $ 725,040 | $ 683,866 |
| Long-term borrowings | 135,000 | 153,000 |
| Subordinated debentures | 24,119 | 24,119 |
| Accrued interest payable and other liabilities | 2,533 | 2,999 |
| Total liabilities | 886,692 | 863,984 |
| Stockholders' Equity | | |
| Preferred stock, $0.01 par value, 1,000,000 shares authorized; | | |
| Preferred stock series "A", 437,500 shares issued and outstanding | 4 | 4 |
| Preferred stock series "B", 23,393 shares issued and outstanding | - | - |
| Common stock, $0.01 par value, 20,000,000 shares authorized; | | |
| 10,066,679 shares issued and outstanding | 101 | 101 |
| Additional paid-in capital | 73,820 | 73,522 |

| | | | | |
|---|---|---|---|---|
| Retained earnings | | 35,287 | | 50,040 |
| | | | | |
| Total stockholders' equity | | 109,212 | | 123,667 |
| | | | | |
| Total liabilities and stockholders' equity | $ | 995,904 | $ | 987,651 |

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

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(dollars in thousands, except per share data)

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Interest Income | | | | |
| Loans, including fees | $13,278 | $14,910 | $39,760 | $47,271 |
| Securities, taxable | 33 | 17 | 65 | 56 |
| Other | 36 | 121 | 11 | 613 |
| Total interest income | 13,347 | 15,048 | 39,836 | 47,940 |
| Interest Expense | | | | |
| Deposits | 4,727 | 6,133 | 15,551 | 19,800 |
| Short-term borrowings | - | 25 | 12 | 62 |
| Long-term borrowings and subordinated debentures | 1,569 | 1,766 | 4,821 | 5,659 |
| Total interest expense | 6,296 | 7,924 | 20,384 | 25,521 |
| Net interest income | 7,051 | 7,124 | 19,452 | 22,419 |
| Provision for loan losses | 8,909 | 2,865 | 25,944 | 4,365 |
| Net interest income (loss) after provision for loan losses | (1,858) | 4,259 | (6,492) | 18,054 |
| Non-Interest Income | | | | |
| Real estate commissions | 108 | 329 | 519 | 707 |
| Real estate management fees | 231 | 159 | 551 | 506 |
| Mortgage banking activities | 37 | 27 | 241 | 316 |
| Other | 194 | 222 | 604 | 580 |
| Total non-interest income | 570 | 737 | 1,915 | 2,109 |
| Non-Interest Expenses | | | | |
| Compensation and related expenses | 2,408 | 2,076 | 7,072 | 6,829 |
| Occupancy | 343 | 437 | 985 | 1,253 |
| Foreclosed real estate expenses, net | 1,339 | 32 | 3,005 | 426 |
| Legal fees | 308 | 213 | 731 | 483 |
| FDIC assessments and regulatory expense | 593 | 189 | 1,414 | 537 |
| Other | 989 | 1,041 | 3,027 | 3,280 |
| Total non-interest expenses | 5,980 | 3,988 | 16,234 | 12,808 |
| Income (loss) before income tax provision (benefit) | (7,268) | 1,008 | (20,811) | 7,355 |
| Income tax provision (benefit) | (2,909) | 421 | (8,234) | 3,012 |

| | | | | |
|---|---|---|---|---|
| Net income (loss) | ($4,359) | $587 | ($12,577) | $4,343 |
| Amortization of discount on preferred stock | 68 | - | 203 | - |
| Dividends on preferred stock | 363 | - | 1,068 | - |
| Net income (loss) available to common stockholders | ($4,790) | $587 | ($13,848) | $4,343 |
| Basic earnings (loss) per share | ($.48) | $.06 | ($1.38) | $.43 |
| Diluted earnings (loss) per share | ($.48) | $.06 | ($1.38) | $.43 |
| Common stock dividends declared per share | $.03 | $.06 | $.09 | $.18 |

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

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(dollars in thousands)

| | For the Nine Months Ended September 30, 2009 | 2008 |
|---|---|---|
| Cash Flows from Operating Activities | | |
| Net income (loss) | $ (12,577 ) | $ 4,343 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Amortization of deferred loan fees | (1,602 ) | (1,990 ) |
| Net amortization of premiums and discounts | 2 | 3 |
| Provision for loan losses | 25,944 | 4,365 |
| Provision for depreciation | 959 | 1,011 |
| Gain on sale of loans | (241 ) | (225 ) |
| Loss on sale of foreclosed real estate | 83 | - |
| Proceeds from loans sold to others | 24,660 | 16,903 |
| Loans originated for sale | (25,384 ) | (15,577 ) |
| Stock-based compensation expense | 96 | 96 |
| Increase in net deferred tax asset | (8,607 ) | (81 ) |
| Increase in accrued interest receivable and other assets | (294 ) | (294 ) |
| Decrease in accrued interest payable and other liabilities | (466 ) | (471 ) |
| Net cash provided by operating activities | 2,573 | 8,083 |
| Cash Flows from Investing Activities | | |
| Purchase of investment securities held to maturity | (7,999 ) | - |
| Proceeds from maturing investment securities | - | 1,000 |
| Principal collected on mortgage-backed securities | 113 | 24 |
| Net (increase) decrease in loans | 16,176 | (6,116 ) |
| Proceeds from sale of foreclosed real estate | 5,961 | 4,922 |
| Investment in premises and equipment | (127 ) | (285 ) |
| Proceeds from disposal of premises and equipment | 24 | - |
| Net redemption of Federal Home Loan Bank of Atlanta stock | 85 | 1,478 |
| Net cash provided by investing activities | 14,233 | 1,023 |

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) CONTINUED
(dollars in thousands)

| | For the Nine Months Ended September 30, 2009 | 2008 |
|---|---|---|
| Cash Flows from Financing Activities | | |
| Net increase in deposits | 41,174 | 36,889 |
| Decrease in short-term borrowings | - | (15,000 ) |
| Additional borrowed funds, long term | - | 30,000 |
| Repayment of borrowed funds, long-term | (18,000 ) | (52,000 ) |
| Common stock dividend paid | (906 ) | (1,812 ) |
| Series A preferred stock dividend paid | (210 ) | - |
| Series B preferred stock dividend paid | (858 ) | - |
| Net cash provided by (used in) financing activities | 21,200 | (1,923 ) |
| Increase in cash and cash equivalents | 38,006 | 7,183 |
| Cash and cash equivalents at beginning of year | 32,305 | 11,266 |
| Cash and cash equivalents at end of period | $70,311 | $18,449 |
| Supplemental disclosure of cash flows information: | | |
| Cash paid during period for: | | |
| Interest | $20,667 | $25,916 |
| Income taxes | $2,458 | $3,844 |
| Transfer of loans to foreclosed real estate | $19,649 | $13,494 |

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

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. (the "Company"), and its wholly owned subsidiary, 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 financial statements.

During the quarter ended September 30, 2009, the common stock of Louis Hyatt, Inc. was contributed to the Bank from the Company.

Note 2 - Basis of Presentation

The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the "FASB". The FASB sets generally accepted accounting principles ("GAAP") that the Company 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 FASB finalized the Codification effective for periods ending on or after September 15, 2009.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America for complete 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 and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2009 or any other interim period. In preparing the accompanying consolidated financial statements, management has evaluated subsequent events through November 12, 2009 (the financial statement issue date). The unaudited consolidated financial statements for the three and nine months ended September 30, 2009 should be read in conjunction with the audited consolidated financial statements and related notes, which were included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

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

Certain prior year's amounts have been reclassified to conform to the current year's method of presentation.

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 5 – Change in Accounting Estimate

Beginning in the three month period ending June 30, 2009, management changed the method it used to estimate its allowance for loan losses based on a request of its primary regulator. Prior to this change, management based its estimate on reviewing individual impaired loans for any required specific reserves, plus applying a general reserve on all other performing loans. The specific reserve was based on current fair values less estimated selling and disposal costs on loans where management felt appropriate. The general reserve was calculated based on a weighted average of the prior three calendar years' historical performance for loan losses, plus qualitative factors management deemed appropriate for the various loan portfolios.

Beginning with the three month period ending June 30, 2009, management began deducting selling and disposal costs from all fair values when estimating the need for a specific reserve on impaired loans. In addition, the general reserve is now calculated based on a weighted average of the loan losses for the most recent rolling twelve months plus the prior two calendar years historical performance without consideration of qualitative factors.

This change in estimate resulted in an additional charge to the loan loss reserve of approximately $5,000,000, or $0.50 per share for the three months ended June 30, 2009.

Note 6 - Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of shares of common stock outstanding for each period. Diluted earnings (loss) 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 the Company 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 and nine month periods ended September 30, 2009, because they were anti-dilutive, were 113,740 outstanding stock options, a warrant to purchase 556,976 shares of common stock and 437,500 shares of common stock issuable upon conversion of the Company Series A Preferred Stock. For the three and nine month periods ended September 30, 2008, all of the Company's outstanding stock options, which totaled 114,950, were not included in the diluted earnings per share calculation because there were anti-dilutive.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Common shares – weighted average (basic) | 10,066,679 | 10,066,679 | 10,066,679 | 10,066,679 |
| Common share equivalents – weighted average | - | - | - | - |
| Common shares – diluted | 10,066,679 | 10,066,679 | 10,066,679 | 10,066,679 |

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 7 - Guarantees

The Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally all letters of credit, when issued, have expiration dates within one year. The credit risks involved in issuing letters of credit are similar to those that are involved in extending loan facilities to customers. The Company generally holds collateral supporting these commitments. The Company had $11,551,000 of standby letters of credit outstanding as of September 30, 2009. Management believes that the proceeds obtained through a liquidation of collateral would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2009 and December 31, 2008 for guarantees under standby letters of credit issued was not material.

Note 8 - 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 the Company's financial statements. 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. The following table presents the Bank's capital position:

| | Actual at September 30, 2009 | Actual at December 31, 2008 | To Be Well Capitalized Under Prompt Corrective Provisions |
|---|---|---|---|
| Tangible (1) | 12.2% | 13.5% | N/A |
| Tier I Capital (2) | 15.5% | 16.9% | 6.0% |
| Core (1) | 12.2% | 13.5% | 5.0% |
| Total Capital (2) | 16.8% | 18.1% | 10.0% |

(1) To adjusted total assets.
(2) To risk-weighted assets.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 9 - Stock-Based Compensation

The Company has a stock-based compensation plan for directors, officers, and other key employees of the Company. 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 the Company's old stock-based compensation plan. Under the terms of the stock-based compensation plan, the Company 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 of the Company vest immediately, and options granted to officers and employees vest over a five-year period, although the Compensation Committee has the authority to provide for different vesting schedules.

The Company 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. Stock-based compensation expense for the three and nine months ended September 30, 2009 and 2008 totaled $32,000 and $96,000, respectively. There were no options granted or exercised during the three and nine months ended September 30, 2009 and September 30, 2008.

Information regarding the Company's stock-based compensation plan as of and for the nine months ended September 30, 2009 is as follows:

| | 2009 | |
|---|---|---|
| | Shares | Weighted Average Exercise Price Per Share |
| Outstanding at beginning of year | 114,950 | $15.87 |
| Options granted | - | - |
| Exercised | - | - |
| Forfeited | (1,210) | $15.62 |
| Outstanding at period end | 113,740 | $15.87 |
| Exercisable at period end | 84,085 | $15.86 |

The aggregate intrinsic value of the options outstanding at both the beginning of the year and the end of period and the options exercisable at the end of the period are $0.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

The following table summarizes the stock options outstanding and exercisable as of September 30, 2009.

| | Options Outstanding and Exercisable | | |
|---|---|---|---|
| Range of Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| $15.62 | 71,077 | 1.39 | $15.62 |
| $17.18 | 13,008 | 1.39 | $17.18 |
| $15.62-$17.18 | 84,085 | 1.39 | $15.86 |

As of September 30, 2009, there was $178,000 of total unrecognized stock-based compensation cost related to non-vested stock options, which is expected to be recognized over a period of seventeen months.

Note 10 - Investment Securities

The amortized cost and fair value of investment securities held to maturity are as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (dollars in thousands) | | |
| September 30, 2009: | | | | |
| US Treasury securities | $ 7,999 | $ 43 | $ ( - ) | $ 8,042 |
| Residential mortgage backed securities | 1,230 | 26 | (14 ) | 1,242 |
| Total | $ 9,229 | $ 69 | $ (14 ) | $ 9,284 |
| December 31, 2008: | | | | |
| Residential mortgage backed securities | $ 1,345 | $ 11 | $ (27 ) | $ 1,329 |

The estimated fair value of debt securities at September 30, 2009, by contractual maturity are shown below. Expected maturities may differ from contractual maturities, because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands) | In One Year Or Less | After One Year Through Five Years | After Five Years Through Ten Years | After Ten Years | Total |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Securities held-to-maturity | | | | | |
| US Treasury securities | $1,998 | $6,044 | $- | $- | $8,042 |
| Residential mortgage backed | - | - | - | $1,242 | 1,242 |
| Total securities | $1,998 | $6,044 | $- | $1,242 | $9,284 |

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

On September 30, 2009 and December 31, 2008, there were $947,000 and 0, respectively, in mortgage-backed securities pledged as collateral.

The following tables show 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 September 30, 2009 and December 31, 2008. Included in the table is one mortgage backed security for 2009 and two for 2008. Management believes that the unrealized losses are the result of interest rate levels differing from those existing at the time of purchase of the securities and actual and estimated prepayment speeds. These unrealized losses are considered temporary as they reflect fair values on September 30, 2009 and December 31, 2008 and are subject to change daily as interest rates fluctuate.

| | Less than 12 months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2009: | | | (dollars in thousands) | | | |
| Mortgage backed securities | $- | $- | $268 | ($14) | $268 | ($14) |
| December 31, 2008: | | | | | | |
| Mortgage backed securities | $- | $- | $1,151 | ($27) | $1,151 | ($27) |

Note 11 - Fair Values of Financial Instruments

FASB ASC 820 Fair Value Measurements and Disclosures establishes a fair value hierarchy that prioritizes the inputs to valuation methods 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 under FASB ASC 820 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.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

The following table summarizes the valuation of assets re-measured at fair value on a nonrecurring basis, by the above FASB ASC 820 pricing methodology as of September 30, 2009 and December 31, 2008 (dollars in thousands):

| | Fair Value Measurement at September 30, 2009 Using | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Loans accounted for under FASB ASC 310-10-35 | $48,994 | - | - | $48,994 |
| Foreclosed real estate | 17,877 | - | - | 17,877 |

| | Fair Value Measurement at December 31, 2008 Using | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Loans accounted for under FASB ASC 310-10-35 | $32,054 | - | - | $32,054 |
| Foreclosed real estate | 6,317 | - | - | 6,317 |

There were no liabilities that were required to be re-measured on a nonrecurring basis during the period ended September 30, 2009 or the year ended December 31, 2008.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Bank's financial instruments at September 30, 2009 and December 31, 2008.

Cash and cash equivalents:
The carrying amount reported in the statement of financial condition for cash and cash equivalents approximate those assets fair values.

Investment Securities:
The Company utilizes a third party source to determine the fair value of its fixed income 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, some of which are heavily influenced by unobservable inputs.

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 September 30, 2009.

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 was estimated using discounted cash flow analyses, using market interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

These rates were used for each aggregated category of loans as reported on the Office of Thrift Supervision Quarterly Report.

Impaired loans are those that are accounted for under FASB ASC 310-10-35, in which the Company has measured impairment generally based 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 $65,743,000 and $37,444,000 at September 30, 2009 and December 31, 2008, respectively, less their valuation allowances of $16,749,000 and $5,390,000 at September 30, 2009 and December 31, 2008, respectively, as determined under FASB ASC 310-10-35.

Foreclosed Real Estate:
Real estate acquired through or in the process of foreclosure is recorded and included in the following disclosure at 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 an 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.

Accrued interest receivable and payable:
The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

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, the Company 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, the Company has disclosed that the carrying value approximates the fair value.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Off-balance sheet financial instruments:
Fair values for the Company’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.

The following table summarizes the roll forward of level 3 assets for the nine months ended September 30, 2009 (dollars in thousands):

| | Impaired Loans | Foreclosed Real Estate |
|---|---|---|
| Balance at December 31, 2008 | $ 32,054 | $ 6,317 |
| Transfer to foreclosed real estate | (10,755 ) | 19,649 |
| Additions | 57,507 | 213 |
| Additional allowances | (11,358 ) | (2,258 ) |
| Paid off/sold | (18,454 ) | (6,044 ) |
| Balance at September 30, 2009 | $ 48,994 | $ 17,877 |

The $11,358,000 in additional reserves recorded against impaired loans was included in the provision for loan losses on the statement of operations for the nine months ended September 30, 2009. The $2,258,000 of additional reserves recorded against foreclosed real estate was included in non-interest expenses on the statement of operations for the nine months ended September 30, 2009. Included in the $19,649,000 of loans transferred to foreclosed real estate were 17 loans totaling $12,709,000 that were not considered impaired per FASB ASC 310-10-35.

The estimated fair values of the Company's financial instruments were as follows:

| | September 30, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (dollars in thousands) | | | |
| Financial Assets | | | | |
| Cash and cash equivalents | $ 70,311 | $ 70,311 | $ 32,305 | $ 32,305 |
| Investment securities | 9,229 | 9,284 | 1,345 | 1,329 |
| FHLB stock | 8,609 | 8,609 | 8,694 | 8,694 |
| Loans held for sale | 1,418 | 1,418 | 453 | 453 |
| Loans receivable, net | 835,756 | 873,124 | 896,006 | 899,991 |
| Accrued interest receivable | 3,530 | 3,530 | 4,363 | 4,363 |
| Financial Liabilities | | | | |
| Deposits | $ 725,040 | $ 728,475 | $ 683,866 | $ 687,067 |
| FHLB advances | 135,000 | 126,883 | 153,000 | 151,142 |
| Subordinated debentures | 24,119 | 24,119 | 24,119 | 24,119 |
| Accrued interest payable | 837 | 837 | 1,120 | 1,120 |

| | | | | |
|---|---|---|---|---|
| Off Balance Sheet Commitments | $ - | $ - | $ - | $ - |

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 12 - Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 168, "The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162," ("SFAS 168"). SFAS 168 establishes the FASB Accounting Standards Codification TM ("Codification") as the source of authoritative generally accepted accounting principles ("GAAP") for nongovernmental entities. The Codification does not change GAAP. Instead, it takes the thousands of individual pronouncements that currently comprise GAAP and reorganizes them into approximately 90 accounting Topics, and displays all Topics using a consistent structure. Contents in each Topic are further organized first by Subtopic, then Section and finally Paragraph. The Paragraph level is the only level that contains substantive content. Citing particular content in the Codification involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure. FASB suggests that all citations begin with "FASB ASC," were ASC stands for Accounting Standards Codification. Changes to the ASC subsequent to June 30, 2009 are referred to as Accounting Standards Updates ("ASU").

In conjunction with the issuance of SFAS 168, the FASB also issued its first Accounting Standards Update No. 2009-1, "Topic 105 – Generally Accepted Accounting Principles" ("ASU 2009-1") which includes SFAS 168 in its entirety as a transition to the ASC. ASU 2009-1 is effective for interim and annual periods ending after September 15, 2009 and did not have an impact on the Company's financial position or results of operations but changed the referencing system for accounting standards.

In April 2009, the FASB issued FASB ASC 820-10-65-4, Fair Value Measurements and Disclosures Overall Transition. FASB ASC 820, Fair Value Measurements and Disclosures, defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FASB ASC 820-10-65-4 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased. It also includes guidance on identifying circumstances when a transaction may not be considered orderly.

FASB ASC 820-10-65-4 provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with FASB ASC 820.

This clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. This provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

This was effective for interim and annual reporting periods ending after June 15, 2009. The adoption of FASB ASC 820-10-65-4 did not have a material impact on the consolidated financial statements.

In April 2009, the FASB issued FASB ASC 825-10-65-1, Financial Instruments Overall Transition. FASB ASC 825-10-65-1 amends FASB ASC 825-10-50, Financial Instruments Overall Disclosure, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This also amends FASB ASC 270-10-05, Interim Reporting Overall Background to require those disclosures in summarized financial information at interim reporting periods.

This was effective for interim and annual reporting periods ending after June 15, 2009. The adoption of FASB ASC 825-10-65-1 did not have a material impact on the consolidated financial statements.

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

The Company

The Company is a savings and loan holding company chartered as a corporation in the state of Maryland, and is headquartered in Annapolis, Maryland. It conducts business primarily through three subsidiaries: the Bank, a federal savings bank, which is the Company's principal subsidiary; Louis Hyatt, Inc., a subsidiary of the Bank, doing business as Hyatt Commercial, a commercial real estate brokerage and property management company; and SBI Mortgage Company, which holds mortgages that do not meet the underwriting criteria of the Bank, and is the parent company of Crownsville Development Corporation, 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. The Bank originates loans in its primary market of Anne Arundel County, Maryland and, to a lesser extent, in other parts of Maryland, Delaware and Virginia. The Company's common stock trades under the symbol "SVBI" on the Nasdaq Capital Market.

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 for financial strength 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.

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 typical identify forward-looking statements. The Company'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, the success of the Bank's strategy; changes in the economy and interest rates both in the nation and Company's general market area; federal and state regulation; and competition and other factors detailed from time to time in the Company's filings with the Securities and Exchange Commission (the "SEC"), including "Item 1A. Risk Factors" contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Critical Accounting Policies

The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the “FASB”. The FASB sets generally accepted accounting principles (“GAAP”) that the Company 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 FASB finalized the Codification effective for periods ending on or after September 15, 2009.

The Company’s significant accounting policies are set forth in Note 1 of the audited consolidated financial statements as of December 31, 2008 which were included in the Company’s Annual Report on Form 10-K. Of these significant accounting policies, the Company considers its policy regarding the allowance for loan losses to be its most critical accounting policy, because it requires management’s most subjective and complex judgments. In addition, changes in economic conditions can have a significant impact on the allowance for loan losses and therefore on the provision for loan losses and results of operations. The Company 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. See Note 5 of the consolidated financial statements for discussion of changes in the methods used by management to estimate the allowance for loan losses. The Company’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

The Company provides a wide range of retail and commercial banking services. Deposit services include checking, individual retirement accounts, money market, savings and time deposit accounts. Loan services include various types of commercial, consumer, and real estate lending. The Company also provides ATMs, corporate cash management services, debit cards, Internet banking including on-line bill pay, mortgage lending, safe deposit boxes, and telephone banking, among other products and services.

The Company continues to experience challenges similarly faced by many financial institutions resulting from the slowdown in the financial and real estate markets, including increased loan delinquencies and a decrease in the demand for certain loan products including mortgage, construction, development, and land acquisition loans. Continued declines in real estate values, home sales volumes and financial stress on borrowers as a result of the uncertain economic environment, including job losses and other factors, have adversely affected our borrowers. As a result, the Company has increased its provision for loan losses to $25,944,000 for the nine months ended September 30, 2009, compared to $4,365,000 for the same period in 2008. Also, strong competition for new loans and deposits has caused the interest rate spread between the Company’s cost of funds and what it earns on loans to decrease from 2008 levels. This was primarily due to an increase in non-accrual loans, and to decreases in interest rates earned on loans outpacing the decreases in interest paid on deposits and other borrowings. The Company’s net loan portfolio has decreased $60,250,000, or 6.7%, to $835,756,000 at September 30, 2009, compared to $896,006,000 at December 31, 2008.

The Company has experienced an increase in delinquent loans and has increased its provision for loan losses from 2008 levels accordingly. The Company believes that the allowance for loan losses was adequate at September 30, 2009.

The Company will be challenged to grow its loan portfolio in the current economic downturn. In addition to the challenges faced with the current economy, the Company may also experience less loan demand if interest rates rise. The Company will continue to manage loan and deposit pricing against the risks of rising costs of its deposits and borrowings.

The Company's success continues to be dependent on the strength of the markets in which it operates, including the Company's ability to originate and grow its mortgage loans, as well as its continuing ability to maintain comparatively low overhead costs.

If the volatility in the market and the economy continues or worsens, the Company's 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 decreased by $4,946,000, or 842.6%, to a net loss of $4,359,000 for the third quarter of 2009, compared to net income of $587,000 for the third quarter of 2008. Basic and diluted earnings (loss) per share decreased by $.54, or 900.0%, to ($.48) for the third quarter of 2009 compared to $.06 for the third quarter of 2008. Net income decreased by $16,920,000, or 389.6%, to a net loss of $12,577,000 for the nine months ended September 30, 2009, compared to net income of $4,343,000 for the same period in 2008. Basic and diluted earnings (loss) per share decreased by $1.81, or 420.9% to ($1.38) for the nine months ended September 30, 2009 compared to $.43 for the same period in 2008. The decrease in net income (loss) and basic and diluted earnings (loss) per share over last year was primarily the result of management's decision to increase the allowance for loan loss by approximately $26,000,000 for the nine months ended September 30, 2009 compared to approximately $4,400,000 for the nine months ended September 30, 2008. In addition, the Company's interest rate spread decreased by 0.44%, to 2.51% for the nine months ended September 30, 2009, compared to 2.95% for the same period in 2008. The interest rate spread is the difference between the Company's cost of funds and yield on earning assets.

Net interest income, which is interest earned net of interest expense, decreased by $73,000, or 1.0%, to $7,051,000 for the third quarter of 2009, compared to $7,124,000 for the third quarter of 2008. Net interest income decreased by $2,967,000, or 13.2%, to $19,452,000 for the nine months ended September 30, 2009, compared to $22,419,000 for the same period in 2008. The primary reasons for the decrease in net interest income was an increase in non-accrual loans, and that the interest rates earned on the Company's loan portfolio have decreased faster than the interest rates paid on the Company's interest bearing liabilities. Net interest margin for the nine months ended September 30, 2009 was 2.81%, compared to 3.27% for the same period in 2008.

The provision for loan losses increased by $6,044,000, or 211.0%, to $8,909,000 for the third quarter of 2009, compared to $2,865,000 for the third quarter of 2008. The provision for loan losses for the nine months ended September 30, 2009 increased by $21,579,000, or 494.4%, to $25,944,000, compared to $4,365,000 for the same period in 2008. The provision for loan losses and allowance for loan losses are based on management's judgment and evaluation of the loan portfolio. Management assesses the adequacy of the allowance for loan losses and the need for any addition thereto, by considering the nature and size of the loan portfolio, overall portfolio quality, review of specific problem loans, economic conditions that may affect the borrowers' ability to pay or the value of property securing loans, and other relevant factors. While management believes the current allowance for loan losses is adequate, changing economic and other conditions may require future adjustments to the allowance for loan losses. For additional discussion, see "Asset Quality" below.

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Total non-interest income decreased by $167,000, or 22.7%, to $570,000 for the third quarter of 2009, compared to $737,000 for the third quarter of 2008. The primary reason for the decrease in non-interest income was a decrease in real estate commissions partially offset by an increase in management fees by Hyatt Commercial. Real estate commissions decreased $221,000, or 67.2%, to $108,000 for the third quarter of 2009, compared to $329,000 for the third quarter of 2008, while real estate management fees increased $72,000, or 45.3%, to $231,000 for the third quarter of 2009, compared to $159,000 for the third quarter of 2008. Total non-interest income decreased by $194,000, or 9.2%, to $1,915,000 for the nine months ended September 30, 2009, compared to $2,109,000 for the same period in 2008. The primary reason for the decrease during the first nine months of 2009, compared to the first nine months of 2008 was a decrease in real estate commissions. Real estate commissions decreased $188,000, or 26.6%, to $519,000 for the nine months ended September 30, 2009, compared to $707,000 for the same period in 2008. The primary reason for this decline was the economic downturn which resulted in less activity in the sale and lease of commercial property.

Total non-interest expenses increased by $1,992,000, or 49.9%, to $5,980,000 for the third quarter of 2009, compared to $3,988,000 for the third quarter of 2008. Total non-interest expenses increased by $3,426,000, or 26.7%, to $16,234,000 for the nine months ended September 30, 2009, compared to $12,808,000 for the same period in 2008. Compensation and related expenses increased by $332,000, or 16.0%, to $2,408,000 for the third quarter of 2009, compared to $2,076,000 for the same period in 2008. Total compensation and related expenses increased by $243,000, or 3.6%, to $7,072,000 for the nine months ended September 30, 2009 compared to $6,829,000 for the same period in 2008. This increase was primarily because of an increase in salary expense and health insurance from newly hired employees, partially offset by lower commissions. Net occupancy costs decreased by $94,000, or 21.5%, to $343,000 for the third quarter of 2009, compared to $437,000 for the third quarter of 2008. Net occupancy costs decreased by $268,000, or 21.4%, to $985,000 for the nine months ended September 30, 2009, compared to $1,253,000 for the same period in 2008. This decrease was the result of a decrease in net rents, utilities and depreciation expenses at its headquarters. Foreclosed real estate expenses, net increased by $1,307,000, or 4,084.4%, to $1,339,000 for the third quarter of 2009, compared to $32,000 for the same period in 2008. Foreclosed real estate expenses, net increased by $2,579,000, or 605.4%, to $3,005,000 for the nine months ended September 30, 2009, compared to $426,000 for the same period in 2008. This increase was the result of additional foreclosure expenses incurred due to the economic environment and the increase in loan foreclosures experienced by the Company. Legal fees increased by $95,000, or 44.6%, to $308,000 for the third quarter of 2009, compared to $213,000 for the same period in 2008. Legal fees increased by $248,000, or 51.3%, to $731,000 for the nine months ended September 30, 2009, compared to $483,000 for the same period in 2008. This increase is the result of increased legal activity relating to loan delinquencies. FDIC assessments and regulatory expense increased by $404,000, or 213.8%, to $593,000 for the third quarter of 2009, compared to $189,000 for the same period in 2008. FDIC assessments and regulatory expense increased by $877,000, or 163.3%, to $1,414,000 for the nine months ended September 30, 2009, compared to $537,000 for the same period in 2008. This increase is due to a one time FDIC special assessment that occurred in the second quarter of 2009, and higher assessment rates in 2009 compared to 2008.

Income Taxes

The income tax provision decreased by $3,330,000, or 791.0%, to a tax benefit of $2,909,000 for the third quarter of 2009, compared to a tax expense of $421,000 for the third quarter of 2008. The income tax provision for the first nine months of 2009 decreased by $11,246,000, or 373.4%, to a tax benefit of $8,234,000, compared to a tax expense of $3,012,000 for the first nine months of 2008. The decrease is consistent with the decrease in pretax income (loss). The effective tax rate for the nine months ended September 30, 2009 was (39.6%) compared to 41.0% for the same period in 2008. During the nine months ended September 30, 2009, the Company's net deferred tax asset increased by $8,607,000 primarily relating to the tax effect of the additional $25,944,000 increase in its loan loss reserve. The change in the effective tax rate was primarily due to a valuation allowance placed on a portion of the deferred tax asset resulting from current state operating loss carryforwards. There was no valuation allowance on the federal operating loss carryforwards because of the two year carryback and twenty year carryforward period.

Analysis of Financial Condition

Total assets increased $8,253,000, or 0.8%, to $995,904,000 at September 30, 2009, compared to $987,651,000 at December 31, 2008. Cash and cash equivalents increased by $38,006,000, or 117.6%, to $70,311,000 at September 30, 2009, compared to $32,305,000 at December 31, 2008. This increase was primarily in federal funds sold and correspondent bank balances. The loan portfolio decreased, as net loans receivable decreased $60,250,000, or 6.7%, to $835,756,000 at September 30, 2009, compared to $896,006,000 at December 31, 2008. This decrease was the result of the continued general slowdown in loan demand during the first nine months of 2009 as well as the increase in the allowance for loan losses. Loans held for sale increased $965,000, or 213.0%, to $1,418,000 at September 30, 2009, compared to $453,000 at December 31, 2008. This increase was primarily due to the timing of loans pending sale as of September 30, 2009. Other real estate owned increased $11,560,000, or 183.0% to $17,877,000 at September 30, 2009 compared to $6,317,000 at December 31, 2008. Total deposits increased $41,174,000, or 6.0%, to $725,040,000 at September 30, 2009 compared to $683,866,000 at December 31, 2008. This increase was primarily attributable to the popularity of Safe Harbor savings accounts. FHLB Atlanta borrowings decreased $18,000,000, or 11.8%, to $135,000,000 at September 30, 2009, compared to $153,000,000 as of December 31, 2008. This was a result of paying off long-term FHLB Atlanta advances at maturity with proceeds received from increased deposits and loan payoffs.

Stockholders’ Equity

Total stockholders’ equity decreased $14,455,000, or 11.7%, to $109,212,000 at September 30, 2009 compared to $123,667,000 as of December 31, 2008. This decrease was primarily a result of the net loss for the first nine months, and the dividends paid to its common and preferred stockholders.

Asset Quality

Non-performing assets consist of non-accrual loans, restructured loans, and other real estate owned (foreclosed properties). Loans are placed in non-accrual status, when in the opinion of management, the collection of additional interest is unlikely or a specific loan meets the criteria for non-accrual status established by regulatory authorities (those loans 90 or more days in arrears). No interest is taken into income on non-accrual loans. A loan remains on non-accrual status until the loan is current as to both principal and interest and collectability is reasonably assured.

Foreclosed real estate includes properties that have been repossessed or acquired in complete or partial satisfaction of debt. Such properties, which are held for resale, are carried at fair value, less a reduction for the estimated selling expenses.

The following table presents the Company’s non-performing assets as of September 30, 2009 and December 31, 2008 (dollars in thousands):

| | | September 30, 2009 | | Number of loans | | December 31, 2008 | | Number of loans |
|---|---|---|---|---|---|---|---|---|
| Loans accounted for on a non-accrual basis: | | | | | | | | |
| Mortgage loans: | | | | | | | | |
| Residential - consumer | $ | 45,249 | | 86 | $ | 30,769 | | 73 |
| Residential - builder | | 17,417 | | 48 | | 20,970 | | 45 |
| Commercial | | 4,741 | | 12 | | 3,047 | | 11 |
| Non-mortgage loans: | | | | | | | | |
| Consumer | | 11 | | 2 | | 9 | | 2 |
| Commercial loans | | 1,383 | | 3 | | - | | - |
| Total non-accrual loans | $ | 68,801 | | 151 | $ | 54,795 | | 131 |
| Accruing loans greater than 90 days past due | $ | - | | | $ | - | | |
| Foreclosed real-estate | $ | 17,877 | | | $ | 6,317 | | |
| Total non-performing assets | $ | 86,678 | | | $ | 61,112 | | |
| Total troubled debt restructurings | $ | 22,552 | | 32 | $ | 2,142 | | 3 |
| Total non-accrual loans to net loans | | 8.2 | % | | | 6.1 | % | |
| Allowance for loan losses | $ | 34,009 | | | $ | 14,813 | | |
| Allowance to total loans | | 3.9 | % | | | 1.6 | % | |
| Allowance for loan losses to total non-performing loans, including loans contractually past due 90 days or more | | 49.4 | % | | | 27.0 | % | |
| Total non-accrual and accruing loans greater than 90 days past due to total assets | | 6.9 | % | | | 5.5 | % | |
| Total non-performing assets to total assets | | 8.7 | % | | | 6.2 | % | |

The allowance for loan losses is based on management's judgment and evaluation of the loan portfolio. Management assesses the adequacy of the allowance for loan losses and the need for any addition thereto, by considering the nature and size of the loan portfolio, overall portfolio quality, review of specific problem loans, economic conditions that may affect the borrowers' ability to pay or the value of property securing loans, and other relevant factors. While management believes the current allowance is adequate, changing economic and market conditions may require future adjustments to the allowance for loan losses.

The following table summarizes the change in impaired loans for the nine months ended September 30, 2009 (dollars in thousands):

| | |
|---|---|
| Impaired loans at December 31, 2008 | $69,836 |

| | |
|---|---|
| Added to impaired loans | 102,507 |
| Gross loans transferred to foreclosed real estate | (23,464 ) |
| Paid off prior to foreclosure | (20,346 ) |
| Impaired loans at September 30, 2009 | $128,533 |

Included in the above impaired loans amount at September 30, 2009 was $59,732,000 of loans that were not in non-accrual status. In addition, there was a total of $77,837,000 of residential real estate loans included in impaired loans at September 30, 2009, of which $60,795,000 were to consumers and $17,042,000 were to builders. Impaired loans are individually reviewed by management to determine their estimated fair value, and a specific reserve is established, if necessary, for the difference between the original carrying value of any loan and its estimated fair value.

As of September 30, 2009, the Company had foreclosed real estate consisting of 43 residential properties with a carrying value of $17,877,000. During the nine month period ended September 30, 2009, the Company sold 19 properties previously included in foreclosed real estate. The following table summarizes the changes in foreclosed real estate for the nine months ended September 30, 2009 (dollars in thousands):

| | |
|---|---|
| Foreclosed real estate at December 31, 2008 | $6,317 |
| Transferred from loans, net of charge-offs of $3,815 | 19,649 |
| Property improvements | 213 |
| Property sold | (6,044 ) |
| Additional allowances | (2,258 ) |
| Foreclosed real estate at September 30, 2009 | $17,877 |

Liquidity

The Company'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. Based on the internal and external sources available, the Company's liquidity position exceeded anticipated short-term and long-term needs as of September 30, 2009. Additionally, loan payments, maturities, deposit growth and earnings contribute a flow of funds available to meet liquidity requirements.

In assessing its liquidity, the management of the Company 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 so that the Company may take advantage of business opportunities.

Management believes it 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 $372,463,000 at September 30, 2009. Based on past experience, management believes that a significant portion of such deposits will remain with the Company. At September 30, 2009, the Company had commitments to originate mortgage loans of $9,485,000, unadvanced home equity lines of credit of $19,871,000, unadvanced construction commitments of $48,335,000, unused lines of credit of $27,422,000, and commitments under standby letters of credit of $11,551,000. The Company 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 September 30, 2009, outstanding FHLB Atlanta borrowings totaled $135,000,000, and the Company had available to it an additional $163,490,000 in borrowing availability from FHLB Atlanta.

Net cash provided by operating activities decreased $5,510,000 to $2,573,000 for the nine months ended September 30, 2009, compared to $8,083,000 for the same period in 2008. This decrease was primarily the result of a net loss, higher loans originated for sale to others and an increase in deferred tax assets, partially offset by the increase in the provision for loan losses in 2009. Net cash provided by investing activities increased $13,210,000 to $14,233,000 for the nine months ended September 30, 2009, compared to $1,023,000 for the same period in 2008. This increase was primarily due to higher cash proceeds from the decrease in loans during the nine months ended September 30, 2009, compared to the same period in 2008. In financing activities, net cash increased by $23,123,000 to $21,200,000 provided by financing activities for the nine months ended September 30, 2009, compared to $1,923,000 used in financing activity for the same period in 2008. This increase was primarily due to lower repayments of FHLB Atlanta borrowings in 2009 and an increase in deposits during the nine months ended September 30, 2009, compared to the same period in 2008.

Federal Home Loan Bank of Atlanta Line of Credit

The Bank has an available line of credit, secured by various loans in its portfolio, in the amount of thirty percent (30%) of its total assets, with the FHLB Atlanta. As of September 30, 2009, the total available line of credit with the FHLB Atlanta was approximately $298,000,000, of which $135,000,000 was outstanding. 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 September 30, 2009 (dollars in thousands):

| Principal Amount | Rate | Maturity |
|---|---|---|
| $ 10,000 | 3.083% | 2009 |
| 10,000 | 5.000% | 2010 |
| - | - | 2011 |
| - | - | 2012 |
| - | - | 2013 |
| 115,000 | 2.579% to 4.340% | Thereafter |
| $ 135,000 | | |

Subordinated Debentures

As of September 30, 2009, the Company 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 the Company and Wells Fargo Bank, National Association, as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of LIBOR (0.05094% as of September 30, 2009) 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 the Company, as defined in the 2035 Indenture. The 2035 Debentures are first redeemable, in whole or in part, by the Company 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 the Company. 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. The Company has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee.

On November 15, 2008, the Company 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 the Company's Series A 8.0% Non-Cumulative Convertible Preferred Stock and the Company's Subordinated Note in the original principal amount of $50,000.

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 the Company 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.

Preferred Stock

The Company 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 the Company’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 the Company’s common stock. At the option of the Company, on and after December 31, 2013, at any time and from time to time, some or all of the Series A Preferred Stock may be converted into shares of the Company’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 the Company'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 the Company’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 the Company's board of directors declare any dividends on the Series A Preferred Stock and any unpaid dividends shall not be cumulative.

On November 21, 2008, the Company entered into an agreement with the United States Department of the Treasury (“Treasury”), pursuant to which the Company 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 the Company’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. The Series B Preferred Stock qualifies as Tier 1 capital and will pay cumulative compounding dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter.

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

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, the Company’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 the Company’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.

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. If the Company receives aggregate gross cash proceeds of not less than $23,393,000 from Qualified Equity Offerings on or prior to December 31, 2009, the number of shares of common stock issuable pursuant to Treasury's exercise of the Warrant will be reduced by one half of the original number of shares, taking into account all adjustments, underlying the Warrant. 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.

The Company's ability to declare dividends on its common stock are limited by the terms of the Company's Series A preferred stock and Series B preferred stock. The Company 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, prior to November 21, 2011, unless the Company has redeemed the Series B preferred stock or the Treasury Department has transferred the Series B preferred stock to a third party, the Company may not, without the consent of the Treasury (1) declare or pay any dividend or make any distribution on its common stock (other than regular quarterly cash dividends of not more than $0.06 per share) or (2) redeem, purchase or acquire any shares of our common stock or other equity or capital securities, other than in connection with benefit plans consistent with past practice and certain other circumstances specified in the Letter Agreement with the Treasury Department.

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 the Company's distribution of the average consolidated balance sheets and net interest analysis for the nine months ended September 30, 2009 and September 30, 2008:

| | Nine Months Ended September 30, 2009 | | | Nine Months Ended September 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Average Volume | Interest | Yield/Cost | Average Volume | Interest | Yield/Cost |
| | | | (dollars in thousands) | | | |
| ASSETS | | | | | | |
| Loans (1) | $888,331 | $39,760 | 5.97% | $891,045 | $47,271 | 7.07% |
| Held to maturity securities(2) | 3,132 | 65 | 2.77% | 1,368 | 56 | 5.46% |
| Other interest-earning assets (3) | 31,748 | 11 | 0.05% | 20,682 | 613 | 3.95% |
| Total interest-earning assets | 923,211 | 39,836 | 5.75% | 913,095 | 47,940 | 7.00% |
| Non-interest earning assets | 63,301 | | | 49,567 | | |
| Total assets | $986,512 | | | $962,662 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | | | |
| Savings and checking deposits | $178,616 | 2,749 | 2.05% | $119,170 | 1,495 | 1.67% |
| Certificates of deposit | 514,098 | 12,802 | 3.32% | 550,233 | 18,305 | 4.44% |
| Borrowings | 145,249 | 4,833 | 4.44% | 170,666 | 5,721 | 4.47% |
| Total interest-bearing liabilities | 837,963 | 20,384 | 3.24% | 840,069 | 25,521 | 4.05% |
| Non-interest bearing liabilities | 29,740 | | | 25,077 | | |
| Stockholders' equity | 118,809 | | | 97,516 | | |
| Total liabilities and stockholders' equity | $986,512 | | | $962,662 | | |
| Net interest income and interest rate spread | | $19,452 | 2.51% | | $22,419 | 2.95% |
| Net interest margin | | | 2.81% | | | 3.27% |
| Average interest-earning assets to average interest-bearing liabilities | | | 110.17% | | | 108.69% |

(1) Non-accrual loans are included in the average balances and in the computation of yields.

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

(3)

Other interest-earning assets includes interest-bearing deposits in other banks, federal funds sold and FHLB stock investments.

Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk in excess of the amount recognized in the statement of financial position. The contract amounts of these instruments express the extent of involvement the Company has in each class of financial instruments.

The Company's exposure to credit loss from non-performance by the other party to the above mentioned financial instruments is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount has been recognized in the statement of financial condition at September 30, 2009 as a liability for credit loss.

Off-balance sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows (dollars in thousands):

| Financial Instruments Whose Contract Amounts Represent Credit Risk | Contract Amount At September 30, 2009 |
|---|---|
| Standby letters of credit | $11,551 |
| Home equity lines of credit | 19,871 |
| Unadvanced construction commitments | 48,335 |
| Mortgage loan commitments | 9,485 |
| Lines of credit | 27,422 |
| Loans sold with limited repurchase provisions | 12,027 |

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in market risk since December 31, 2008, as reported in the Company's Form 10-K filed with the SEC on March 11, 2009.

Item 4. Controls and Procedures

Under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2009. Based upon this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2009, the Company's disclosure controls and procedures were effective in reaching a reasonable level of assurance that (i) information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) information required to be disclosed by the Company in its reports that it files or submits under the Exchange Act is accumulated and communicated to its management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2009 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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 the Company 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 the Company, 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 the Company’s financial condition and results of operations.

### Item 1A. Risk Factors

The following risk factor should be considered in addition to the other information set forth in this report, and 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, 2008. If any of the risks actually occur, the Company’s business, financial condition or results of operations could be materially and adversely affected. The risk factors in our Annual Report on Form 10-K have not materially changed. The following risk and the risks described in our Annual Report on Form 10-K are not the only risks facing our Company. 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. The Company’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 the Company described in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

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

None.

### Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit No. | Description |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002 |
| 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 |

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. |
| November 12, 2009 | Alan J. Hyatt___________________________<br>Alan J. Hyatt, Chairman of the Board, President and Chief Executive Officer<br>(Principal Executive Officer) |
| November 12, 2009 | Thomas G. Bevivino______________________<br>Thomas G. Bevivino, Executive Vice President and Chief Financial Officer<br>(Principal Financial Officer) |

Exhibit Index

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