SEVERN BANCORP INC
Form 10-Q
November 10, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

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 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 files). Yes þ 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 (Do not check if a smaller reporting company) o 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 10, 2011: 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, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 32,037	$ 33,339
Interest-bearing deposits in other banks	40,476	20,149
Federal funds sold	19,275	17,467
Cash and cash equivalents	91,788	70,955
Investment securities held to maturity	40,325	27,311
Loans held for sale	4,998	3,426
Loans receivable, net of allowance for loan losses of $30,358 and $29,871, respectively	711,170	778,937
Premises and equipment, net	27,489	28,327
Foreclosed real estate	19,158	20,955
Federal Home Loan Bank stock at cost	7,140	7,692
Accrued interest receivable and other assets	23,945	24,940
Total assets	$ 926,013	$ 962,543
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits	$ 678,717	$ 714,776
Long-term borrowings	115,000	115,000
Subordinated debentures	24,119	24,119
Accrued interest payable and other liabilities	2,962	2,548
Total liabilities	820,798	856,443
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	74,604	74,352

Retained earnings		30,506		31,643
Total stockholders' equity		105,215		106,100
Total liabilities and stockholders' equity	$	926,013	$	962,543

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,	
	2011	2010	2011	2010
Interest Income				
Loans, including fees	$ 10,764	$ 11,930	$ 33,340	$ 37,476
Securities, taxable	170	106	442	157
Other	57	47	161	91
Total interest income	10,991	12,083	33,943	37,724
Interest Expense				
Deposits	2,557	3,465	8,053	10,627
Long-term borrowings and subordinated debentures	1,299	1,441	3,875	4,254
Total interest expense	3,856	4,906	11,928	14,881
Net interest income	7,135	7,177	22,015	22,843
Provision for loan losses	850	1,000	4,471	4,544
Net interest income after provision for loan losses	6,285	6,177	17,544	18,299
Non-Interest Income				
Real estate commissions	187	160	421	390
Real estate management fees	168	154	469	438
Mortgage banking activities	118	202	300	423
Other	155	208	447	573
Total non-interest income	628	724	1,637	1,824
Non-Interest Expenses				
Compensation and related expenses	2,543	2,467	7,668	7,425
Occupancy	316	405	872	1,158
Foreclosed real estate expenses, net	1,242	1,065	4,676	4,328
Legal fees	239	379	676	988
FDIC assessments and regulatory expense	553	594	1,695	1,723
Other	1,066	1,121	3,252	3,406
	5,959	6,031	18,839	19,028

Total non-interest expenses											
Income before income tax provision		954			870			342			1,095
Income tax provision		403			385			190			545
Net income		551			485			152			550
Amortization of discount on preferred stock		(68	)		(68	)		(203	)		(203	)
Dividends on preferred stock		(362	)		(362	)		(1,087	)		(1,087	)
Net income (loss) available to common stockholders	$	121		$	55		$	(1,138	)	$	(740	)
Basic earnings (loss) per share	$	.01		$	.01		$	(.11	)	$	(.07	)
Diluted earnings (loss) per share	$	.01		$	.01		$	(.11	)	$	(.07	)
Common stock dividends declared per share	$	-		$	-		$	-		$	-

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 CASH FLOWS (UNAUDITED)
(dollars in thousands)

	For the Nine Months Ended September 30, 2011	2010
Cash Flows from Operating Activities		
Net income	$ 152	$ 550
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred loan fees	(1,038)	(1,158)
Net amortization of premiums and discounts	124	57
Provision for loan losses	4,471	4,544
Provision for depreciation	936	924
Gain on sale of loans	(300)	(423)
Loss on sale of foreclosed real estate	619	299
Provision for foreclosed real estate losses	3,151	2,907
Proceeds from loans sold to others	24,649	33,856
Loans originated for sale	(25,921)	(37,272)
Stock-based compensation expense	50	119
(Increase) decrease in net deferred tax asset	(317)	2,117
Decrease in accrued interest receivable and other assets	1,312	776
Increase in accrued interest payable and other liabilities	414	1,534
Net cash provided by operating activities	8,302	8,830
Cash Flows from Investing Activities		
Purchase of investment securities held to maturity	(19,447)	(20,359)
Proceeds from maturing investment securities	6,000	1,000
Principal collected on mortgage-backed securities	309	21
Net decrease in loans	50,731	6,302
Proceeds from sale of foreclosed real estate	12,134	17,968
Investment in foreclosed real estate	(504)	(228)
Investment in premises and equipment	(98)	(351)
Redemption of Federal Home Loan Bank Stock	552	617
Net cash provided by investing activities	49,677	4,970

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

	For the Nine Months Ended September 30, 2011	2010
Cash Flows from Financing Activities		
Net increase (decrease) in deposits	(36,059)	6,990
Series “A” preferred stock dividend paid	(210)	(210)
Series “B” preferred stock dividend paid	(877)	(877)
Net cash (used in) provided by financing activities	(37,146)	5,903
Increase in cash and cash equivalents	20,833	19,703
Cash and cash equivalents at beginning of year	70,955	51,401
Cash and cash equivalents at end of period	$91,788	$71,104
Supplemental disclosure of cash flows information:		
Cash paid during period for:		
Interest	$11,952	$14,873
Income taxes	$476	$-
Transfer of loans to foreclosed real estate	$13,603	$18,155

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

Note 2 - Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with GAAP for interim financial information and in accordance with the instructions to Form 10-Q. Accordingly, they do not include all of the disclosures required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation of the results of operations for the interim periods presented have been made. Such adjustments were of a normal recurring nature. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2011 or any other interim period. The unaudited consolidated financial statements for the three and nine months ended September 30, 2011 should be read in conjunction with the audited consolidated financial statements and related notes, which were included in Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2010. These consolidated financial statements consider events that occurred through the date the consolidated financial statements were issued.

Note 3 - Cash Flow Presentation

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

Note 4 – Reclassifications

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

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 5 - 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 Bancorp relate to outstanding stock options, warrants, and convertible preferred stock, and are determined using the treasury stock method.

Not included in the diluted earnings per share calculation for the three and nine month periods ended September 30, 2011, because they were anti-dilutive, were 100,000 shares of common stock issuable upon exercise of outstanding stock options, 556,976 shares of common stock issuable upon the exercise of a warrant and 437,500 shares of common stock issuable upon conversion of Bancorp's Series A Preferred Stock. Not included in the diluted earnings per share calculation for the three and nine month periods ended September 30, 2010, because they were anti-dilutive, were 192,565 shares of common stock issuable upon the exercise of outstanding stock options, 556,976 shares of common stock issuable upon the exercise of a warrant and 437,500 shares of common stock issuable upon conversion of Bancorp's Series A Preferred Stock.

	Three Months Ended September 30		Nine Months Ended September 30	
	2011	2010	2011	2010
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

Note 6 - Guarantees

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

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 7 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by the regulators that, if undertaken, could have a direct material effect on Bancorp's consolidated financial statements. 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, 2011		Actual at December 31, 2010		To Be Well Capitalized Under Prompt Corrective Provisions	
Tangible (1)	12.4	%	12.3	%	N/A	
Tier I Capital (2)	16.6	%	15.6	%	6.0	%
Core (1)	12.4	%	12.3	%	5.0	%
Total Capital (2)	17.9	%	16.8	%	10.0	%

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

Note 8 - Stock-Based Compensation

Bancorp has a stock-based compensation plan for directors, officers, and other key employees of Bancorp. The aggregate number of shares of common stock that may be issued with respect to the awards granted under the plan is 500,000 plus any shares forfeited under Bancorp's old stock-based compensation plan. Under the terms of the stock-based compensation plan, Bancorp has the ability to grant various stock compensation incentives, including stock options, stock appreciation rights, and restricted stock. The stock-based compensation is granted under terms and conditions determined by the Compensation Committee of the Board of Directors. Under the stock-based compensation plan, stock options generally have a maximum term of ten years, and are granted with an exercise price at least equal to the fair market value of the common stock on the date the options are granted. Generally, options granted to directors of Bancorp 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.

Bancorp follows FASB ASC 718, "Compensation – Stock Compensation", to account for stock-based compensation. FASB ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statement of operations at fair value. FASB ASC 718 requires an entity to recognize the expense of employee services received in share-based payment transactions and measure the expense based on the grant date fair value of the award. The expense is recognized over the period during which an employee is required to provide service in exchange for the award.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 8 - Stock-Based Compensation - continued

On March 16, 2010, Bancorp granted 100,000 options to certain officers and employees to purchase shares of Bancorp's stock at a price ranging from $4.13 to $4.54 per share. The options vest over a five year period from the date of grant.

The grant-date fair value of options granted was $2.12. The fair value of the options awarded under the option plan is estimated on the date of grant using the Black-Scholes valuation model, which is dependent upon certain assumptions as presented below:

Expected life (in years)	5.00	
Risk-free interest rate	2.37	%
Expected volatility	58.78	%
Expected dividend yield	0.00	%

The expected life of the options was estimated using the average vesting period of the options granted and represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the grant date. Volatility of Bancorp's stock price was based on historical volatility. Dividend yield was based on management's projection of future dividends.

There were no options granted during the nine months ended September 30, 2011.

Stock-based compensation expense for the three and nine months ended September 30, 2011 totaled $21,000 and $50,000, respectively. Stock-based compensation expense for the three and nine months ended September 30, 2010 totaled $43,000 and $119,000, respectively. There were no options granted or exercised during the nine months ended September 30, 2011 and 100,000 options granted and no options exercised during the nine months ended September 30, 2010.

Information regarding Bancorp's stock-based compensation plan as of and for the nine months ended September 30, 2011 is as follows:

	2011	
	Shares	Weighted Average Price
Options outstanding, December 31, 2010	190,750	$ 9.79
Options granted	-	-

Options exercised	-		-
Options forfeited	(90,750)	$	15.93
Options outstanding, September 30, 2011	100,000	$	4.21
Options exercisable, September 30, 2011	30,834	$	4.21

The aggregate intrinsic value of the options outstanding as of September 30, 2011 and December 31, 2010 was $0.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 8 - Stock-Based Compensation - continued

The following table summarizes the stock options outstanding and exercisable as of September 30, 2011.

Options Outstanding and Exercisable			
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
$4.13	24,667	3.46	$4.13
$4.54	6,167	3.46	$4.54
$4.13-$4.54	30,834	3.46	$4.21

As of September 30, 2011, there was $147,000 of total unrecognized stock-based compensation expense related to non-vested stock options, which is expected to be recognized over a period of forty-two months.

Note 9 - Investment Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2011:				
US Treasury securities	$ 34,481	$ 1,380	$ (1)	$ 35,860
US Agency securities	5,186	51	-	5,237
US government sponsored				
mortgage-backed securities	658	49	-	707
Total	$ 40,325	$ 1,480	$ (1)	$ 41,804
December 31, 2010:				
US Treasury securities	$ 21,104	$ 223	$ (2)	$ 21,325
US Agency securities	5,233	-	(37)	5,196
US Government sponsored				
mortgage-backed securities	974	61	-	1,035
Total	$ 27,311	$ 284	$ (39)	$ 27,556

The estimated fair value of debt securities at September 30, 2011, 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.

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED
Note 9 - Investment Securities - continued

	Held to Maturity (dollars in thousands) Amortized Cost	Estimated Fair Value
Due in one year or less	$ 7,005	$ 7,031
Due from one year to five years	24,431	25,190
Due from five years to ten years	8,231	8,876
US government sponsored mortgage-backed securities	658	707
	$ 40,325	$ 41,804

On September 30, 2011 and December 31, 2010, there were $7,439,000 and $8,760,000, respectively, in US Treasury securities and 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, 2011 and December 31, 2010. Included in the table are one treasury security in 2011 and one treasury security and five agency securities in 2010. 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 and are not necessarily related to the credit quality of the issuers of the securities. In addition, Bancorp does not intend to sell, nor does it believe it will be more likely than not that it will be required to sell, any impaired securities prior to a recovery of amortized cost. These unrealized losses are considered temporary as they reflect fair values on September 30, 2011 and December 31, 2010 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, 2011:			(dollars in thousands)			
US Treasury securities	$ 1,005	$ (1)	$ -	$ (-)	$ 1,005	$ (1)
US Agency securities	-	(-)	-	(-)	-	(-)
Total	$ 1,005	$ (1)	$ -	$ (-)	$ 1,005	$ (1)

December 31, 2010:																	
US Treasury securities	$	1,033	$	(2	)	$	-	$	(-	)	$	1,033	$	(2	)		
US Agency securities		5,196		(37	)		-		(-	)		5,196		(37	)		
Total	$	6,229	$	(39	)	$	-	$	(-	)	$	6,229	$	(39	)		

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SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable

Loans receivable consist of the following:	September 30 2011	December 31 2010
	(dollars in thousands)	
Residential mortgage, total	$ 304,567	$ 326,255
Individually evaluated for impairment	48,804	59,189
Collectively evaluated for impairment	255,763	267,066
Home equity, total	42,639	43,501
Individually evaluated for impairment	1,087	975
Collectively evaluated for impairment	41,552	42,526
Lines of credit, total	35,059	36,642
Individually evaluated for impairment	3,198	4,564
Collectively evaluated for impairment	31,861	32,078
Commercial real estate, total	205,456	212,477
Individually evaluated for impairment	19,804	23,683
Collectively evaluated for impairment	185,652	188,794
Construction, land acquisition and development, total	103,630	144,098
Individually evaluated for impairment	30,534	21,937
Collectively evaluated for impairment	73,096	122,161
Land, total	59,639	63,155
Individually evaluated for impairment	9,037	10,196
Collectively evaluated for impairment	50,602	52,959
Commercial non-real estate, total	5,082	8,434
Individually evaluated for impairment	486	305
Collectively evaluated for impairment	4,596	8,129
Consumer, total	1,965	1,302
Individually evaluated for impairment	925	61
Collectively evaluated for impairment	1,040	1,241
Total Loans	758,037	835,864
Individually evaluated for impairment	113,875	120,910
Collectively evaluated for impairment	644,162	714,954
Less		

Loans in process	(13,912)	(23,851)
Allowance for loan losses	(30,358)	(29,871)
Deferred loan origination fees and costs, net	(2,597)	(3,205)
	$ 711,170	$ 778,937

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

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

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

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

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

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

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

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

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

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

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

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

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

For such loans that are classified as impaired, an allowance is established when the current market value of the underlying collateral less its estimated disposal costs is lower than the carrying value of that loan. For loans that are not solely collateral dependent, an allowance is established when the present value of the expected

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

future cash flows of the impaired loan is lower than the carrying value of that loan. The general component relates to loans that are classified as doubtful, substandard or special mention that are not considered impaired, as well as non-classified loans. The general reserve is based on historical loss experience adjusted for qualitative factors. Management uses the historical loss experience for the preceding three fiscal years and the twelve months ended one month prior to the reporting date when calculating the general reserve.

This historical loss data is weighted heavier to more recent periods. There have been no changes to these look-back periods during the periods presented in the Consolidated Statements of Operations. These qualitative factors include:

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

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

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

Bancorp determines the likelihood that a borrower will pay all amounts due according to the contractual terms of the loan agreement by assessing various factors, including: (i) personal financial statements of net worth, cash flow statements and tax returns (for individual borrowers) and (ii) financial and operating statements, tax returns and financial projections (for legal entity borrowers). Bancorp's evaluation is primarily focused on various key financial metrics, including net worth, leverage ratios, debt service coverage and liquidity.

Bancorp continues to accrue interest on impaired loans that are not in non-accrual status. These loans are less than 90 days in arrears, but are deemed impaired because it is probable, based on current information and events, that the borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement. Cash receipts for these impaired loans are applied to the principal and interest due.

Interest on impaired loans that are in non-accrual status is accounted for on a cash basis until qualifying for return to accrual basis. Cash receipts for these non-accrual loans are applied to principal.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable - Continued

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

Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

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

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 – Loans Receivable – Continued

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

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

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

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

Bancorp recognized $707,000 and $1,220,000 of interest income and capitalized interest in its loan portfolio from interest reserves during the nine months ended September 30, 2011 and 2010, respectively. None of the loans where interest reserves were recorded as capitalized interest were non-performing.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED
Note 10 - Loans Receivable - Continued

The following is a summary of the allowance for loan losses at September 30, 2011 and December 31, 2010 and for the three and nine month periods ended September 30, 2011 and the year ended December 31, 2010 (dollars in thousands):

	Total	Residential Mortgage	Acquisition and Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Twelve months December 2010 Beginning Balance	$34,693	$19,621	$1,492	$5,539	$20	$5,506	$82	$2,425	$8
Provision	5,744	3,443	2,505	1,782	438	(1,034)	49	(1,446)	7
Charge-offs	(10,666)	(6,825)	-	(3,096)	-	(523)	-	(217)	(5)
Recoveries	100	100	-	-	-	-	-	-	-
Ending Balance	$29,871	$16,339	$3,997	$4,225	$458	$3,949	$131	$762	$10
Ending balance related to:									
Loans individually evaluated for impairment	$14,540	$8,149	$2,645	$2,282	$264	$766	$-	$434	$-
Loans collectively evaluated for impairment	$15,331	$8,190	$1,352	$1,943	$194	$3,183	$131	$328	$10
Nine months September 2011 Beginning Balance	$29,871	$16,339	$3,997	$4,225	$458	$3,949	$131	$762	$10
Provision	4,471	(900)	3,436	(760)	(52)	871	691	443	742
Charge-offs	(3,984)	(1,921)	(741)	(811)	-	(497)	-	(12)	(2)
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	$30,358	$13,518	$6,692	$2,654	$406	$4,323	$822	$1,193	$750
Ending balance related to:									
Loans individually evaluated for impairment	$14,542	$6,514	$3,532	$1,600	$150	$1,055	$159	$791	$741
Loans collectively evaluated for	$15,816	$7,004	$3,160	$1,054	$256	$3,268	$663	$402	$9

impairment

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SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Three months September 2011	Total	Residential Mortgage	Acquisition and Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Beginning Balance	$31,103	$ 13,394	$ 6,868	$3,679	$395	$ 4,298	$ 391	$1,325	$753
Provision	850	512	(23)	(431)	11	485	431	(132)	(3)
Charge-offs	(1,595)	(388)	(153)	(594)	-	(460)	-	-	-
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	$30,358	$ 13,518	$ 6,692	$2,654	$406	$ 4,323	$ 822	$1,193	$750

SEVERN BANCORP, INC. AND SUBSIDIARIES
Annapolis, Maryland

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

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

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

The following table presents Bancorp's non-performing assets as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	September 30, 2011	Number of loans	December 31, 2010	Number of loans
Loans accounted for on a non-accrual basis:				
Residential mortgage	$ 11,644	32	$ 18,778	46
Home equity	418	4	118	2
Lines of credit	1,971	3	4,265	8
Commercial real estate	1,671	3	1,927	6
Acquisition and development	15,792	17	15,160	17
Land	4,089	13	5,890	21
Commercial non-real estate	5	1	-	-
Consumer	34	3	26	2
Total non-accrual loans	$ 35,624	76	$ 46,164	102
Accruing loans greater than 90 days past due	$ -		$ -	
Foreclosed real-estate	$ 19,158		$ 20,955	
Total non-performing assets	$ 54,782		$ 67,119	
Total troubled debt restructurings	$ 62,888	116	$ 72,029	135
Total non-accrual loans to net loans	5.0 %		5.9 %	
Allowance for loan losses	$ 30,358		$ 29,871	
Allowance to total loans	4.1 %		3.7 %	

Allowance for loan losses to total non-performing loans, including loans contractually past due 90 days or more	85.2	%	64.7	%
Total non-accrual and accruing loans greater than 90 days past due to total assets	3.8	%	4.8	%
Total non-performing assets to total assets	5.9	%	7.0	%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following tables summarize impaired loans at September 30, 2011 and December 31, 2010 and the three and nine months ended September 30, 2011 and the year ended December 31, 2010 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
September 30, 2011					
Residential mortgage	$ 31,082	$ 6,514	$ 17,723	$ 48,805	$ 48,805
Home equity	888	791	199	1,087	1,087
Lines of credit	601	150	2,597	3,198	3,198
Commercial real estate	4,296	1,055	15,508	19,804	19,804
Acquisition and development	21,556	3,532	8,978	30,534	30,534
Land	3,622	1,600	5,415	9,037	9,037
Commercial non-real estate	177	159	309	486	486
Consumer	826	741	98	924	924
Total impaired loans	$ 63,048	$ 14,542	$ 50,827	$ 113,875	$ 113,875

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
December 31, 2010					
Residential mortgage	$ 38,251	$ 8,149	$ 20,938	$ 59,189	$ 59,189
Home equity	568	434	407	975	975
Lines of credit	836	264	3,728	4,564	4,564
Commercial real estate	3,975	766	19,708	23,683	23,683

Acquisition and development		17,273		2,645		4,664		21,937		21,937
Land		6,567		2,282		3,629		10,196		10,196
Commercial non-real estate		-		-		305		305		305
Consumer		-		-		61		61		61
Total impaired loans	$	67,470	$	14,540	$	53,440	$	120,910	$	120,910

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SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Nine months September 30, 2011						
Residential mortgage	$ 31,215	$ 723	$ 17,996	$ 587	$ 49,211	$ 1,310
Home equity	888	17	199	4	1,087	21
Lines of credit	604	23	2,597	43	3,201	66
Commercial real estate	4,318	152	15,576	712	19,894	864
Acquisition and development	22,014	674	9,126	216	31,140	890
Land	3,637	141	5,415	94	9,052	235
Commercial non-real estate	177	-	311	16	488	16
Consumer	826	-	98	-	924	-
Total impaired loans	$ 63,679	$ 1,730	$ 51,318	$ 1,672	$ 114,997	$ 3,402

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Three months September 30, 2011						
Residential mortgage	$ 31,094	$ 159	$ 17,810	$ 178	$ 48,904	$ 337
Home equity	888	4	199	1	1,087	5
Lines of credit	604	5	2,597	15	3,201	20
Commercial real estate	4,301	45	15,503	225	19,804	270
	21,560	179	8,986	68	30,546	247

Acquisition and development												
Land		3,627		36		5,414		17		9,041		53
Commercial non-real estate		177		-		311		-		488		-
Consumer		826		-		98		-		924		-
Total impaired loans	$	63,077	$	428	$	50,918	$	504	$	113,995	$	932

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Twelve months December 31, 2010						
Residential mortgage	$ 39,382	$ 1,508	$ 21,611	$ 1,057	$ 60,993	$ 2,565
Home equity	568	21	407	17	975	38
Lines of credit	985	167	3,294	115	4,279	282
Commercial real estate	4,034	248	19,838	1,420	23,872	1,668
Acquisition and development	19,327	1,212	5,307	303	24,634	1,515
Land	6,572	288	3,772	492	10,344	780
Commercial non-real estate	-	-	900	45	900	45
Consumer	-	-	61	-	61	-
Total impaired loans	$ 70,868	$ 3,444	$ 55,190	$ 3,449	$ 126,058	$ 6,893

Changes in impaired loans during the three and nine months ended September 30, 2011 is as follows (dollars in thousands):

	For the three months ended September 30, 2011	For the nine months ended September 30, 2011
Impaired loans at beginning of period	$ 120,201	$ 120,910
Added to impaired loans	6,635	28,690
Gross loans transferred to foreclosed real estate	(6,877)	(16,681)
Paid off prior to foreclosure	(6,084)	(19,044)
Impaired loans at September 30, 2011	$ 113,875	$ 113,875

Bancorp recognized $119,000 and $551,000 and $2,599,000 of interest income on impaired loans using a cash-basis method of accounting for the three and nine months ended September 30, 2011 and the year ended December 31, 2010, respectively. Bancorp did not record any interest income attributable to the change in present value attributable to the passage of time. Bancorp deems its loans to be collateral based, and therefore, assesses impairment based on the net value of the underlying collateral.

Included in the above impaired loans amount at September 30, 2011 was $78,251,000 of loans that are not in non-accrual status. In addition, there was a total of $48,805,000 of residential real estate loans included in impaired loans at September 30, 2011, of which $39,992,000 were to consumers and $8,813,000 to builders. The collateral supporting impaired loans is individually reviewed by management to determine its estimated fair market value, less estimated disposal cost and a specific allowance is established, if necessary, for the difference between the carrying amount of any loan and the estimated fair value of the collateral less estimated disposal cost.

Of the impaired loans, $63,048,000 and $67,470,000 had a specific valuation allowance of $14,542,000 and $14,540,000 at September 30, 2011 and December 31, 2010, respectively. Impaired loans averaged $114,997,000 and $126,058,000 for the nine months ended September 30, 2011 and the year ended December 31, 2010, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2011					
Residential mortgage	$ 262,869	$ 12,835	$ 28,367	$ 496	$ 304,567
Home equity	39,711	1,862	1,066	-	42,639
Lines of credit	29,819	2,450	2,790	-	35,059
Commercial real estate	190,718	7,158	7,580	-	205,456
Acquisition and development	66,662	4,322	32,646	-	103,630
Land	44,730	5,591	9,318	-	59,639
Commercial non-real estate	4,647	38	338	59	5,082
Consumer	1,041	109	23	792	1,965
Total loans	$ 640,197	$ 34,365	$ 82,128	$ 1,347	$ 758,037

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2010					
Residential mortgage	$ 281,027	$ 9,999	$ 35,229	$ -	$ 326,255
Home equity	41,030	1,497	974	-	43,501
Lines of credit	28,979	2,796	4,867	-	36,642
Commercial real estate	197,031	3,667	11,779	-	212,477
Acquisition and development	105,052	13,481	25,565	-	144,098
Land	48,384	5,708	9,063	-	63,155
Commercial non-real estate	8,091	38	305	-	8,434
Consumer	1,243	-	59	-	1,302
Total loans	$ 710,837	$ 37,186	$ 87,841	$ -	$ 835,864

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SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non-Accrual	Total Loans
September 30, 2011							
Residential mortgage	$280,216	$9,730	$2,977	$-	$12,707	$11,644	$304,567
Home equity	41,454	767	-	-	767	418	42,639
Lines of credit	32,746	342	-	-	342	1,971	35,059
Commercial real estate	199,620	3,995	170	-	4,165	1,671	205,456
Acquisition and development	83,622	2,362	1,854	-	4,216	15,792	103,630
Land	53,405	1,655	490	-	2,145	4,089	59,639
Commercial non-real estate	5,077	-	-	-	-	5	5,082
Consumer	1,914	17	-	-	17	34	1,965
Total loans	$698,054	$18,868	$5,491	$-	$24,359	$35,624	$758,037

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non-Accrual	Total Loans
December 31, 2010							
Residential mortgage	$297,793	$5,028	$4,656	$-	$9,684	$18,778	$326,255
Home equity	43,138	115	130	-	245	118	43,501
Lines of credit	29,465	854	2,058	-	2,912	4,265	36,642
Commercial real estate	206,434	3,058	1,058	-	4,116	1,927	212,477
Acquisition and development	122,858	1,950	4,130	-	6,080	15,160	144,098
Land	52,492	3,865	908	-	4,773	5,890	63,155

Commercial non-real estate	8,434	-	-	-	-	-	8,434
Consumer	1,272	4	-	-	4	26	1,302
Total loans	$761,886	$14,874	$12,940	$-	$27,814	$46,164	$835,864

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

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

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

The following tables summarize troubled debt restructurings at September 30, 2011 (dollars in thousands):

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Residential mortgage	69	$ 30,835	$ 30,323
Home equity	-	-	-
Lines of credit	2	372	372
Commercial real estate	8	7,677	7,522
Acquisition and development	9	12,623	12,507
Land	11	3,629	3,451
Commercial non-real estate	-	-	-
Consumer	-	-	-
Total loans	99	$ 55,136	$ 54,175

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted:			
Residential mortgage	9	$ 3,541	$ 3,534
Home equity	1	100	100
Lines of credit	-	-	-
Commercial real estate	1	807	807

Acquisition and development	5		3,994		3,994
Land	1		280		278
Commercial non-real estate	-		-		-
Consumer	-		-		-
Total loans	17	$	8,722	$	8,713

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Bancorp has not purchased, sold or reclassified any loans to held for sale during the periods discussed. Only loans originated specifically for sale are recorded as held for sale at the period ended September 30, 2011 and December 31, 2010.

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

The following tables present newly restructured loans that occurred during the three and nine months ended September 30, 2011:

	Three months ended September 30, 2011					
	Rate Modification	Contracts	Combination Modifications	Contracts	Total	Total Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	$ 598	1	$ 7,387	15	$ 7,985	16
Home equity	-	-	-	-	-	-
Lines of credit	232	1	-	-	232	1
Commercial real estate	-	-	1,595	2	1,595	2
Acquisition and development	-	-	387	1	387	1
Land	-	-	1,367	4	1,367	4
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	$ 830	2	$ 10,736	22	$ 11,566	24
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	$ 552	1	$ 7,314	15	$ 7,866	16

Home equity	-	-	-	-	-	-
Lines of credit	232	1	-	-	232	1
Commercial real estate	-	-	1,636	2	1,636	2
Acquisition and development	-	-	387	1	387	1
Land	-	-	1,361	4	1,361	4
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	$ 784	2	$ 10,698	22	$ 11,482	24

SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable – Continued

	Nine months ended September 30, 2011					
	Rate Modification	Contracts	Combination Modifications	Contracts	Total	Total Contracts
Pre-Modification Outstanding Recorded Investment						
Residential mortgage	$ 817	2	$ 22,015	42	$ 22,832	44
Home equity	-	-	-	-	-	-
Lines of credit	232	1	-	-	232	1
Commercial real estate	262	1	3,887	4	4,149	5
Acquisition and development	3,930	1	6,332	6	10,262	7
Land	552	1	1,811	6	2,363	7
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	$ 5,793	6	$ 34,045	58	$ 39,838	64
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	$ 771	2	$ 21,640	42	$ 22,411	44
Home equity	-	-	-	-	-	-
Lines of credit	232	1	-	-	232	1
Commercial real estate	262	1	3,915	4	4,177	5
Acquisition and development	3,930	1	6,442	6	10,372	7
Land	551	1	1,804	6	2,355	7
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	$ 5,746	6	$ 33,801	58	$ 39,547	64

In addition, the collateral securing the TDR, which is always real estate, is evaluated for impairment based on either an appraisal or broker price opinion. If the borrower performs under the terms of the modification, and the ultimate collectability of all amounts contractually due under the modified terms is not in doubt, the loan is returned to accrual status. There are no loans that have been modified due to the financial difficulties of the borrower that are not considered a TDR.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

Interest on TDRs was accounted for under the following methods as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	Number of Contracts	Accrual Status	Number of Contracts	Non-Accrual Status	Total Number of Contracts	Total Modifications
September 30, 2011						
Residential mortgage	45	$ 17,969	33	$ 15,887	78	$ 33,856
Home equity	1	100	-	-	1	100
Lines of credit	1	140	1	232	2	372
Commercial real estate	6	6,177	3	2,153	9	8,330
Acquisition and development	10	14,430	4	2,071	14	16,501
Land	6	1,925	6	1,804	12	3,729
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	69	$ 40,741	47	$ 22,147	116	$ 62,888
December 31, 2010						
Total loans	88	$ 39,834	47	$ 32,195	135	$ 72,029

Management does not charge off a TDR, or a portion of a TDR, until one of the following conditions has been met:

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

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

Prior to either of the above conditions, a loan is assessed for impairment when a loan becomes a TDR. If, based on management's assessment of the underlying collateral of the loan, it is determined that a reserve is needed, a specific reserve is recorded. That reserve is included in the Allowance for Loan Losses in the Consolidated Statement of Financial Condition.

Bancorp performs A note/B note workout structures as a subset of Bancorp's troubled debt restructuring strategy. The amount of loans restructured using this structure was $4,517,000 as of September 30, 2011.

Under an A note/B note workout structure, the new A note is underwritten in accordance with customary troubled debt restructuring underwriting standards and is reasonably assured of full repayment while the B note is not. The B note is immediately charged off upon restructuring.

If the loan was on accrual prior to the troubled debt restructuring being documented with the loan legally bifurcated into an A note fully supporting accrual status and a B note or amount contractually forgiven and charged off, the A note may remain on accrual status. If the loan was on nonaccrual status at the time the troubled

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

debt restructuring was documented with the loan legally bifurcated into an A note fully supporting accrual status and a B note or amount contractually forgiven and fully charged off, the A note may be returned to accrual status, and risk rated accordingly, after a reasonable period of performance under the troubled debt restructuring terms. Six months of payment performance is generally required to return these loans to accrual status.

The A note will continue to be classified as a troubled debt restructuring and may only be removed from impaired status in years after the restructuring if (a) the restructuring agreement specifies an interest rate equal to or greater than the rate that Bancorp was willing to accept at the time of the restructuring for a new loan with a comparable risk and (b) the loan is not impaired based on the terms specified by the restructuring agreement.

The total TDRs charged off and related allocated allowance for loan losses as of September 30, 2011 and December 31, 2010 are as follows (dollars in thousands):

	September 30, 2011	December 31, 2010
Charge offs	$ -	$ -
Allowance for Loan Losses - Specific	7,825	6,054
	$ 7,825	$ 6,054

Bancorp participates in the government sponsored Home Affordable Refinance Program (“HARP”) and Home Affordable Modification Program (“HAMP”) programs, but only in the capacity as servicer on behalf of investor loans that have been sold.

Mortgage loans serviced for others not included in the accompanying consolidated statements of financial condition totaled $82,707,000 and $82,082,000 at September 30, 2011 and December 31, 2010, respectively.

The Bank 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 consolidated statement of financial condition. The contract amounts of these instruments express the extent of involvement the Bank has in each class of financial instruments.

The Bank'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 Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 10 - Loans Receivable - Continued

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

Financial Instruments Whose Contract Amounts Represent Credit Risk	Contract Amount At September 30, 2011	December 31, 2010
Standby letters of credit	$ 14,372	$ 17,959
Home equity lines of credit	14,830	14,340
Unadvanced construction commitments	13,912	26,662
Mortgage loan commitments	1,493	5,827
Lines of credit	28,725	25,833
Loans sold with limited repurchase provisions	10,474	37,943

Standby letters of credit are conditional commitments issued by the Bank guaranteeing performance by a customer to various municipalities. These guarantees are issued primarily to support performance arrangements, limited to real estate transactions. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of September 30, 2011 and December 31, 2010 for guarantees under standby letters of credit issued is not material.

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

Unadvanced construction commitments are loan commitments made to borrowers for both residential and commercial projects that are either in process or are expected to begin construction shortly. Mortgage loan commitments not reflected in the accompanying statements of financial condition at September 30, 2011 included $1,070,000 at a fixed range of 3.25% to 6.00% and $423,000 at floating rates and at December 31, 2010 included $5,669,000 at a fixed range of 3.625% to 6.25% and $158,000 at floating rates.

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

The Bank has entered into several agreements to sell mortgage loans to third parties. The loans sold under these agreements for the period ended September 30, 2011 and year ended December 31, 2010 were $25,921,000 and $59,113,000, respectively. These agreements contain limited provisions that require the Bank to repurchase a loan if the loan becomes delinquent within the terms specified by the agreement. The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount was recognized in the consolidated statement of financial condition at September 30, 2011 and December 31, 2010 as a liability for credit loss related to these loans.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

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.

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, 2011 and December 31, 2010 (dollars in thousands):

	Fair Value at September 30, 2011			
	Total	Level 1	Level 2	Level 3
Impaired loans	$ 48,506	-	-	$ 48,506
Foreclosed real estate	19,158	-	-	19,158

	Fair Value at December 31, 2010			
	Total	Level 1	Level 2	Level 3
Impaired loans	$ 52,930	-	-	$ 52,930
Foreclosed real estate	20,955	-	-	20,955

There were no liabilities that were required to be re-measured on a nonrecurring basis at September 30, 2011 or December 31, 2010.

The following information should not be interpreted as an estimate of the fair value of Bancorp since a fair value calculation is only provided for a limited portion of Bancorp’s assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between Bancorp’s disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of Bancorp's assets and liabilities at September 30, 2011 and December 31, 2010.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments - Continued

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

Investment Securities:
Bancorp utilizes a third party source to determine the fair value of its 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.

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, 2011 and December 31, 2010.

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

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

Impaired loans are those that are accounted for under FASB ASC 310-10-35, in which Bancorp 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 $63,048,000 and $67,470,000 at September 30, 2011 and December 31, 2010, respectively, less their valuation allowances of $14,542,000 and $14,540,000 at September 30, 2011 and December 31, 2010, 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 above 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. The fair value consisted of the foreclosed real estate balances of $19,158,000 and $20,955,000 at September 30, 2011 and December 31, 2010, respectively, after their write downs of $2,057,000 and $2,839,000 at September 30, 2011 and December 31, 2010, respectively, as determined under FASB ASC 310-10-35. 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.

SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments - Continued

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

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

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

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

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

The following table summarizes the roll forward of level 3 assets for the nine months ended September 30, 2011 and September 30, 2010 (dollars in thousands):

	Impaired Loans	Foreclosed Real Estate
Balance at December 31, 2010	$ 52,930	$ 20,955
Transfer to foreclosed real estate	(11,551)	13,603
Additions	28,977	504
Additional allowances	(2)	(3,151)
Paid off/sold	(21,848)	(12,753)
Balance at September 30, 2011	$ 48,506	$ 19,158

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

	Impaired Loans	Foreclosed Real Estate
Balance at December 31, 2009	$ 50,403	$ 21,574
Transfer to foreclosed real estate	(20,537)	18,155
Additions	40,983	228
Additional allowances	2,291	(2,907)
Paid off/sold	(26,255)	(18,267)
Balance at September 30, 2010	$ 46,885	$ 18,783

The $2,000 in additional allowances recorded against impaired loans was included in the provision for loan losses on the statement of operations for the nine months ended September 30, 2011. The $3,151,000 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, 2011. Included in the $13,603,000 of loans transferred to foreclosed real estate were eleven loans totaling $4,237,000 that were not considered impaired per FASB ASC 310-10-35.

SEVERN BANCORP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) CONTINUED

Note 11 - Fair Values of Financial Instruments – Continued

The estimated fair values of Bancorp's financial instruments as of September 30, 2011 and December 31, 2010 were as follows:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(dollars in thousands)			
Financial Assets				
Cash and cash equivalents	$ 91,788	$ 91,788	$ 70,955	$ 70,955
Investment securities	40,325	41,804	27,311	27,556
FHLB stock	7,140	7,140	7,692	7,692
Loans held for sale	4,998	4,998	3,426	3,426
Loans receivable, net	711,170	746,005	778,937	819,864
Accrued interest receivable	3,606	3,606	3,918	3,918
Financial Liabilities				
Deposits	$ 678,717	$ 682,128	$ 714,776	$ 719,142
FHLB advances	115,000	101,731	115,000	105,546
Subordinated debentures	24,119	24,119	24,119	24,119
Accrued interest payable	670	670	694	694
Off Balance Sheet Commitments	$ -	$ -	$ -	$ -

Note 12 - Recent Accounting Pronouncements

In January 2010, the FASB has issued Accounting Standard Update "ASU" 2010-6, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This ASU requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB's objective is to improve these disclosures and, thus increase the transparency in financial reporting. Specifically, ASU 2010-6 amends Codification Subtopic 820-10 to now require:

- A reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and
- In the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements.

In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures:

- For purposes of reporting fair value measurements for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and

- A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The effect of ASU 2010-06 did not have a material effect on the consolidated financial statements.

In January 2011, the FASB issued ASU 2011-1, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No.2010-20 (ASU 2011-1). The FASB determined that certain provisions relating to troubled debt restructurings (TDRs) should be deferred until additional guidance and clarification on the definition of TDRs is issued.

In April 2011, the FASB issued ASU No. 2011-2, A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring (ASU 2011-2). ASU 2011-2 amends ASC Topic 310 – Receivables, by clarifying guidance for creditors in determining whether a concession has been granted and whether a debtor is experiencing financial difficulties. The amendments are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. ASU 2011-2 also makes disclosure requirements deferred under ASU 2011-1 effective for interim and annual periods beginning on or after June 15, 2011.

In June 2011, the FASB issued amendments to ASU No. 2011-2 to clarify the accounting principles applied to loan modifications, as defined by FASB ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors. The ASU clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The ASU goes on to provide guidance on specific types of modifications such as changes in the interest rate of borrowing, and significant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulty. The amendments to ASU No. 2011-2 are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The effect of ASU 2011-2, as amended, did not have a material effect on the consolidated financial statements.

In June 2011, ASU 2011-4 was issued to amend FASB ASC Topic 820, Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. ASU No. 2011-4 clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. ASU No. 2011-4 also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. ASU No. 2011-4 also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, ASU 2011-4 contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. ASU 2011-4 is effective for interim and annual periods beginning after December 15, 2011.

Bancorp has evaluated the effect of ASU 2011-4, as amended, and believes adoption will not have a material effect on the consolidated financial statements.

In June 2011, ASU No. 2011-5 was issued to amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. ASU No. 2011-5 prohibits the presentation of components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all 3 presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of ASU No. 2011-5 are effective for fiscal years and interim periods beginning after December 15, 2011. Bancorp has evaluated the effect of ASU 2011-5, as amended, and believes adoption will not have a material effect on the consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the preexisting goodwill impairment test under ASC Topic 350, Intangibles – Goodwill and Other. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. Bancorp is evaluating the impact of this ASU on its consolidated financial statements.

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

The Company

Bancorp is a savings and loan holding company chartered as a corporation in the state of Maryland, and is headquartered in Annapolis, Maryland. It conducts business primarily through three subsidiaries: the Bank, a federal savings bank, which is Bancorp'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. Bancorp'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 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," and similar expressions are typically used to i forward-looking statements. Bancorp's operations and actual results could differ significantly from those discussed in the forward-looking statements. Some of the factors that could cause or contribute to such differences include, but are not limited to: changes in general economic conditions and political conditions and by governmental monetary and fiscal policies; changes in the economic conditions of the geographic areas in which Bancorp conducts business; changes in interest rates; a downturn on the real estate markets in which Bancorp conducts business; the high degree of risk exhibited by Bancorp's loan portfolio; environmental liabilities with respect to properties Bancorp has title; changes in federal and state regulation; the effects of the supervisory agreements entered into by each of Bancorp and the Bank with the Office of Thrift Supervision; Bancorp's ability to estimate loan losses; competition; breaches in security or interruptions in Bancorp's information systems; Bancorp's ability to timely develop and implement technology; Bancorp's ability to retain its management team; perception of Bancorp in the market place; Bancorp's ability to maintain effective internal controls over financial reporting and disclosure controls and procedures; and terrorist attacks and threat of actual war; and other factors detailed from time to time in Bancorp's filings with the Securities and Exchange Commission (the "SEC"), including "Item 1A. Risk Factors" contained in Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Critical Accounting Policies

Bancorp's significant accounting policies are set forth in Note 1 of the audited consolidated financial statements as of December 31, 2010 which were included in Bancorp's Annual Report on Form 10-K. Of these significant accounting policies, Bancorp considers its policies regarding the allowance for loan losses and the fair value of foreclosed real estate to be its most critical, because they require 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 the fair value of foreclosed real estate and therefore on the provision for loan losses and the provision for losses on foreclosed real estate and, ultimately, on results of operations. Bancorp has developed policies and procedures for assessing the adequacy of the allowance for loan losses and the fair value of foreclosed real estate, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio and estimated value of foreclosed real estate. Bancorp's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

Overview

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

Bancorp experienced net income for the quarter and nine months ended September 30, 2011, in part due to management's decision to add only a modest amount to the loan loss reserves during the third quarter. While non-performing assets continue to decrease, and loan delinquencies improve, management elected to add to the reserves as it continues to assess its loan portfolio. Bancorp continues to experience challenges it and many other financial institutions face as a result of the weak economic recovery. Some of those challenges, including increased loan delinquencies and a decrease in loan demand have improved from 2008 and 2009, but others, such as declines in the real estate values and financial stress on borrowers as a result of the recession continue. The interest rate spread between Bancorp's cost of funds and what it earns on loans has remained relatively constant from 2009 and 2010 levels.

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

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

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

Results of Operations

Net income increased by $66,000 to net income of $551,000 for the third quarter of 2011, compared to net income of $485,000 for the third quarter of 2010. Basic and diluted earnings per share remained constant at $.01 for the third quarter of 2011 compared to the third quarter of 2010. Net income decreased by $398,000 to a net income of $152,000 for the nine months ended September 30, 2011, compared to net income of $550,000 for the nine months ended September 30, 2010. Basic and diluted earnings (loss) per share decreased by $.04, to ($.11) for the nine months ended September 30, 2011 compared to ($.07) for the nine months ended September 30, 2010.

Net interest income, which is interest earned net of interest expense, decreased by $42,000, or 0.6%, to $7,135,000 for the third quarter of 2011, compared to $7,177,000 for the third quarter of 2010. The primary reason for the decrease in net interest income was a decrease in Bancorp's loan portfolio and a decrease in yield on the loan portfolio, partially offset by a lower cost of funds. Net interest income decreased $828,000, or 3.6%, to $22,015,000 for the nine months ended September 30, 2011, compared to $22,843,000 for the nine months ended September 30, 2010.

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

The provision for loan losses decreased by $150,000, or 15.0%, to $850,000 for the third quarter of 2011, compared to $1,000,000 for the third quarter of 2010. This decrease was a result of management's decision to slightly decrease the provision for loan losses during the quarter ended September 30, 2011, compared to the quarter ended September 30, 2010. The provision for loan losses decreased by $73,000, or 1.6%, to $4,471,000 for the nine months ended September 30, 2011, compared to $4,544,000 for the same period in 2010. Bancorp's total loan portfolio has decreased 8.3% from 2010.

Total non-interest income decreased by $96,000, or 13.3%, to $628,000 for the third quarter of 2011, compared to $724,000 for the third quarter of 2010. The primary reason for the decrease in non-interest income was a decrease in mortgage banking activities, partially offset by increased real estate commissions and management fees by Hyatt Commercial. Total non-interest income decreased by $187,000, or 10.3%, to $1,637,000 for the nine months ended September 30, 2011, compared to $1,824,000 for the same period in 2010. Real estate commissions increased $27,000, or 16.9%, to $187,000 for the third quarter of 2011, compared to $160,000 for the third quarter of 2010. Real estate commissions increased $31,000, or 7.9%, to $421,000 for the nine months ended September 30, 2011, compared to $390,000 for the same period in 2010. This increase was due to higher sales and leasing activity in 2011 compared to 2010. Real estate management fees increased $14,000, or 9.1%, to $168,000 for the third quarter of 2011, compared to $154,000 for the third quarter of 2010. Real estate management fees increased $31,000, or 7.1%, to $469,000 for the nine months ended September 30, 2011, compared to $438,000 for the same period in 2010. This increase was due to increased rates charged for property management. Mortgage banking activities decreased $84,000, or 41.6%, to $118,000 for the third quarter of 2011, compared to $202,000 for the third quarter of 2010. Mortgage banking activities decreased by $123,000, or 29.1%, to $300,000 for the nine months ended September 30, 2011, compared to $423,000 for the same period in 2010. This decrease was due to a decrease of loans sold on the secondary market in 2011 compared to the same period of 2010.

Total non-interest expenses decreased $72,000, or 1.2%, to $5,959,000 for the third quarter of 2011, compared to $6,031,000 for the third quarter of 2010. Total non-interest expenses decreased $189,000, or 1.0%, to $18,839,000 for the nine months ended September 30, 2011, compared to $19,028,000 for the same period in 2010. Compensation and related expenses increased by $76,000, or 3.1%, to $2,543,000 for the third quarter of 2011, compared to $2,467,000 for the third quarter of 2010. Compensation and related expenses increased by $243,000, or 3.3%, to $7,668,000 for the nine months ended September 30, 2011, compared to $7,425,000 for the same period in 2010. This increase was primarily because of vacated positions being filled by newly hired employees during the first and third quarters of 2011. Net occupancy costs decreased by $89,000, or 22.0%, to $316,000 for the third quarter of 2011, compared to $405,000 for the third quarter of 2010. Net occupancy costs decreased by $286,000, or 24.7%, to $872,000 for the nine months ended September 30, 2011, compared to $1,158,000 for the same period in 2010. This decrease was the result of increased rents collected on a previously unoccupied space beginning in the fourth quarter of 2010 which helped offset occupancy costs. Foreclosed real estate expenses, net increased by $177,000, or 16.6%, to $1,242,000 for the third quarter of 2011, compared to $1,065,000 for the third quarter of 2010. Foreclosed real estate expenses, net increased by $348,000, or 8.0%, to $4,676,000 for the nine months ended September 30, 2011, compared to $4,328,000 for the same period in 2010. This increase was due to increased foreclosure activity during 2011. Legal fees decreased by $140,000, or 36.9%, to $239,000 for the third quarter of 2011, compared to $379,000 for the third quarter of 2010. Legal fees decreased $312,000, or 31.6%, to $676,000 for the nine months ended September 30, 2011, compared to $988,000 for the same period in 2010. This decrease was primarily due to Bancorp's ability during 2011 to utilize employees for certain services previously provided by outside legal firms. FDIC assessments and regulatory expense decreased by $41,000, or 6.9% to $553,000 for the third quarter of 2011, compared to $594,000 for the third quarter of 2010. FDIC assessments and regulatory expense decreased by $28,000, or 1.6% to $1,695,000 for the nine months ended September 30, 2011, compared to $1,723,000 for the same period in 2010. This decrease was primarily due to a decrease in customer deposits which drives the FDIC assessment. Other non-interest expenses decreased by $55,000, or 4.9%, to $1,066,000 for the third quarter of 2011 compared to $1,121,000 for the third quarter of 2010. Other non-interest expenses decreased by $154,000, or 4.5%, to $3,252,000 for the nine months ended September 30, 2011 compared to $3,406,000 for the same period in 2010. This decrease was a result of lower advertising, credit reports and office expenses, partially offset by higher marketing expenses.

Income Taxes

Income tax expense increased by $18,000 to $403,000 for the third quarter of 2011 compared to $385,000 for the third quarter of 2010. The effective tax rate for the third quarter of 2011 was 42.2% compared to 44.3% for the third quarter of 2010. Income tax expense decreased by $355,000 to $190,000 for the nine months ended September 30, 2011 compared to $545,000 for the same period in 2010. The effective tax rate for the nine months ended September 30, 2011 was 55.6% compared to 49.8% for the same period in 2010. The increase in the effective tax rates for 2011 was primarily due to a valuation allowance placed on a portion of the deferred tax asset resulting from current state operating loss carryforwards.

Analysis of Financial Condition

Total assets decreased $36,530,000, or 3.8%, to $926,013,000 at September 30, 2011, compared to $962,543,000 at December 31, 2010. Cash and cash equivalents increased by $20,833,000, or 29.4%, to $91,788,000 at September 30, 2011, compared to $70,955,000 at December 31, 2010. This increase was primarily in correspondent bank balances. The loan portfolio decreased, as net loans receivable decreased $67,767,000, or 8.7%, to $711,170,000 at September 30, 2011, compared to $778,937,000 at December 31, 2010. This decrease was the result of the continued general slowdown in loan demand during the first nine months of 2011 and the transfer of $13,603,000 of net loans to foreclosed real estate. Loans held for sale increased $1,572,000, or 45.9%, to $4,998,000 at September 30, 2011, compared to $3,426,000 at December 31, 2010. This increase was primarily due to the timing of loans pending sale as of September 30, 2011. Foreclosed real estate decreased $1,797,000, or 8.6%, to $19,158,000 at September 30, 2011 compared to $20,955,000 at December 31, 2010. This decrease was the result of the timing of foreclosed property sales and new foreclosures. Total deposits decreased $36,059,000, or 5.0%, to $678,717,000 at September 30, 2011 compared to $714,776,000 at December 31, 2010. These changes were primarily the result of Bancorp's continued monitoring of the deposit portfolio and allowing higher rate deposits to leave. Long-term borrowings remained at $115,000,000 at September 30, 2011, compared to December 31, 2010. These borrowings do not mature until 2014 or later and would incur prepayment penalties if paid earlier.

Stockholders' Equity

Total stockholders' equity decreased $885,000, or 0.8%, to $105,215,000 at September 30, 2011 compared to $106,100,000 as of December 31, 2010. This decrease was primarily a result of the dividends paid to Bancorp's preferred stockholders partially offset by net income for the first nine months of 2011.

Liquidity

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

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

Management believes Bancorp has sufficient cash flow and liquidity to meet its current commitments through the next 12 months. Certificates of deposit, which are scheduled to mature in less than one year, totaled $216,331,000 at September 30, 2011. Based on past experience, management believes that a significant portion of such deposits will remain with Bancorp. At September 30, 2011, Bancorp had commitments to originate mortgage loans of $1,493,000, unadvanced home equity lines of credit of $14,830,000, unadvanced construction commitments of $13,912,000, unused lines of credit of $28,725,000 and commitments under standby letters of credit of $14,372,000. Bancorp has the ability to reduce its commitments for new loan originations, adjust other cash outflows, and borrow from FHLB Atlanta should the need arise. As of September 30, 2011, outstanding FHLB Atlanta borrowings totaled $115,000,000, and Bancorp had available to it an additional $71,600,000 in borrowing availability from FHLB Atlanta.

Net cash provided by operating activities decreased $528,000 to $8,302,000 for the nine months ended September 30, 2011, compared to $8,830,000 for the same period in 2010. This decrease was primarily the result of decreases in proceeds from loans sold to others, partially offset by a decrease in loan originations in 2011. Net cash provided by investing activities increased $44,707,000 to $49,677,000 for the nine months ended September 30, 2011, compared to $4,970,000 provided by investing activities for the same period in 2010. This increase was primarily due to a net decrease in loans in 2011. Net cash used in financing activities was $37,146,000 for the nine months ended September 30, 2011, compared to $5,903,000 provided by financing activities for the same period in 2010. This decrease was primarily due to a decrease in deposits in 2011 compared to an increase in deposits during the same period in 2010.

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 twenty percent (20%) of its total assets, with the FHLB Atlanta. As of September 30, 2011, the total available line of credit with the FHLB Atlanta was approximately $186,600,000, of which $115,000,000 was outstanding in the form of long-tem borrowings. The Bank, from time to time, utilizes the line of credit when interest rates are more favorable than obtaining deposits from the public. The following table sets forth information concerning the interest rates and maturity dates of the advances from the FHLB Atlanta as of September 30, 2011 (dollars in thousands):

Principal Amount	Rate	Maturity
$ -	- %	2011
-	- %	2012
-	- %	2013
25,000	2.94% to 4.21 %	2014
40,000	3.71% to 4.34 %	2015

	50,000	2.58% to 4.05 %	Thereafter
$	115,000		

Subordinated Debentures

As of September 30, 2011, Bancorp had outstanding $20,619,000 principal amount of Junior Subordinated Debt Securities Due 2035 (the “2035 Debentures”). The 2035 Debentures were issued pursuant to an Indenture dated as of December 17, 2004 (the “2035 Indenture”) between Bancorp and Wells Fargo Bank, National Association, as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of LIBOR (0.24925% as of September 30, 2011) plus 200 basis points, and mature on January 7, 2035. Payments of principal, interest, premium and other amounts under the 2035 Debentures are subordinated and junior in right of payment to the prior payment in full of all senior indebtedness of Bancorp, as defined in the 2035 Indenture. The 2035 Debentures became redeemable, in whole or in part, by Bancorp on January 7, 2010.

The 2035 Debentures were issued and sold to Severn Capital Trust I (the “Trust”), of which 100% of the common equity is owned by Bancorp. The Trust was formed for the purpose of issuing corporation-obligated mandatorily redeemable Capital Securities (“Capital Securities”) to third-party investors and using the proceeds from the sale of such Capital Securities to purchase the 2035 Debentures. The 2035 Debentures held by the Trust are the sole assets of the Trust. Distributions on the Capital Securities issued by the Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Trust on the 2035 Debentures. The Capital Securities are subject to mandatory redemption, in whole or in part, upon repayment of the 2035 Debentures. Bancorp has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee.

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

The aggregate principal amount of Subordinated Notes outstanding at September 30, 2011 was $3,500,000. The Subordinated Notes earn interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31, 2018. Debt issuance costs totaled $245,000 and are being amortized over 10 years.

Preferred Stock

Bancorp issued a total of 437,500 shares of its Series A 8.0% Non-Cumulative Convertible Preferred Stock (“Series A Preferred Stock”) as part of the private placement offering completed on November 15, 2008. The liquidation preference is $8.00 per share. Each share of Series A Preferred Stock is convertible at the option of the holder into one share of Bancorp’s common stock, subject to adjustment upon certain corporate events. The initial conversion rate is equivalent to an initial conversion price of $8.00 per share of Bancorp’s common stock. At the option of Bancorp, on and after December 31, 2013, at any time and from time to time, some or all of the Series A Preferred Stock may be converted into shares of Bancorp’s common stock at the then-applicable conversion rate. Costs related to the issuance of the preferred stock totaled $247,000 and were netted against the proceeds.

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

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On November 21, 2008, Bancorp entered into an agreement with the United States Department of the Treasury (“Treasury”), pursuant to which Bancorp issued and sold (i) 23,393 shares of its Series B Fixed Rate Cumulative Perpetual Preferred Stock, par value $0.01 per share and liquidation preference $1,000 per share, (the “Series B Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 556,976 shares of Bancorp’s common stock, par value $0.01 per share, for an aggregate purchase price of $23,393,000. Costs related to the issuance of the preferred stock and warrants totaled $45,000 and were netted against the proceeds. The Series B Preferred Stock qualifies as Tier 1 capital and will pay cumulative 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 Bancorp’s existing Series A Preferred Stock, in terms of dividend payments and distributions upon liquidation, dissolution and winding up of Bancorp.

The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, Bancorp’s authorized number of directors will be automatically increased by two and the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, will have the right to elect those directors at Bancorp’s next annual meeting of stockholders or at a special meeting of stockholders called for that purpose. These preferred share directors will be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid.

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

Bancorp’s ability to declare dividends on its common stock are limited by the terms of Bancorp’s Series A preferred stock and Series B preferred stock. Bancorp may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to its common stock in any quarter until the dividend on the Series A Preferred Stock has been declared and paid for such quarter, subject to certain minor exceptions. Additionally, prior to November 21, 2011, unless Bancorp has redeemed the Series B preferred stock or the Treasury Department has transferred the Series B preferred stock to a third party, Bancorp 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 its 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.

On November 23, 2009, Bancorp and the Bank entered into supervisory agreements with its regulators. The agreements require, among other things, that Bancorp and the Bank must obtain prior regulatory approval before any dividends or capital distributions can be made.

Effects of Inflation

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

Average Balance Sheet

The following table presents Bancorp's distribution of the average consolidated balance sheets and net interest analysis for the nine months ended September 30, 2011 and September 30, 2010:

	Nine Months Ended September 30, 2011			Nine Months Ended September 30, 2010		
	Average Volume	Interest	Yield/Cost	Average Volume	Interest	Yield/Cost
			(dollars in thousands)			
ASSETS						
Loans (1)	$763,287	$33,340	5.82%	$827,989	$37,476	6.03%
Held to maturity securities (2)	36,257	442	1.63%	15,917	157	1.32%
Other interest-earning assets (3)	61,832	161	0.35%	47,575	91	0.26%
Total interest-earning assets	861,376	33,943	5.25%	891,481	37,724	5.64%
Non-interest earning assets	86,665			91,250		
Total assets	$948,041			$982,731		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Savings and checking deposits	$288,766	1,767	0.82%	$285,247	3,119	1.46%
Certificates of deposit	410,002	6,286	2.04%	439,330	7,508	2.28%
Borrowings	139,119	3,875	3.71%	149,119	4,254	3.80%
Total interest-bearing liabilities	837,887	11,928	1.90%	873,696	14,881	2.27%
Non-interest bearing liabilities	4,203			4,426		
Stockholders' equity	105,951			104,609		
Total liabilities and stockholders' equity	$948,041			$982,731		
Net interest income and interest rate spread		$22,015	3.35%		$22,843	3.37%
Net interest margin			3.41%			3.42%
Average interest-earning assets to average interest-bearing liabilities			102.80%			102.04%

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

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

(3)

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

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in market risk since December 31, 2010, as reported in Bancorp's Form 10-K filed with the SEC on March 15, 2011.

Item 4. Controls and Procedures

Under the supervision and with the participation of Bancorp's management, including its Chief Executive Officer and Chief Financial Officer, Bancorp has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2011. Based upon this evaluation, Bancorp's Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2011, Bancorp's disclosure controls and procedures were effective in reaching a reasonable level of assurance that (i) information required to be disclosed by Bancorp 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 Bancorp 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 Bancorp'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, 2011 that have materially affected, or are reasonably likely to materially affect, Bancorp'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 Bancorp have been detected. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

The risk factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010 should be carefully considered by you. If any of the risks actually occur, Bancorp's business, financial condition or results of operations could be materially and adversely affected. The risks described in our Annual Report on Form 10-K are not the only risks facing Bancorp. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or results of operations. This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Bancorp's actual results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by Bancorp described in Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. (Removed and Reserved)

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
101	The following financial statements from the Severn Bancorp, Inc. Quarterly Report on Form 10-Q as of September 30, 2011 and for the three and nine months ended September 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Condition; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; and (iv) the Notes to Consolidated Financial Statements. Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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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 10, 2011	_Alan J. Hyatt___________________________ Alan J. Hyatt, Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)
November 10, 2011	_Thomas G. Bevivino______________________ Thomas G. Bevivino, Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)

Exhibit Index

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