MERCANTILE BANKSHARES CORP
Form 10-Q
May 05, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from to

Commission file number 0-5127

MERCANTILE BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-0898572**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2 Hopkins Plaza

Baltimore, Maryland 21201

(Address of principal executive offices) (Zip Code)

(410) 237-5900

(Registrant s telephone number, including area code)

NONE

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

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

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

As of April 29, 2005, 79,491,610 shares of registrant s Common Stock, $2 par value per share, were outstanding.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

MERCANTILE BANKSHARES CORPORATION

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share data)	March 31, 2005	December 31, 2004	March 31, 2004
ASSETS			
Cash and due from banks	**$ 304,969**	$ 244,875	$ 296,077
Interest-bearing deposits in other banks	**158**	158	158
Federal funds sold	**26,901**	101	353,893
Total cash and cash equivalents	**332,028**	245,134	650,128
Investment securities available-for-sale (Note 4)	**2,807,721**	2,908,694	3,006,218
Investment securities held-to-maturity (Note 4) fair value of $20,371 (2005), $21,094 (December 2004) and $28,436 (March 2004)	**19,704**	20,176	26,555
Total investment securities	**2,827,425**	2,928,870	3,032,773
Loans held-for-sale	**24,341**	11,000	38,741
Loans:			
Commercial	**2,797,435**	2,813,325	2,566,692
Commercial real estate	**3,180,853**	3,122,701	2,836,846
Construction	**1,347,365**	1,268,350	1,105,346
Residential real estate	**1,543,778**	1,486,106	1,387,647
Consumer	**1,487,040**	1,484,583	1,473,491
Lease financing	**56,751**	53,368	64,398
Total loans	**10,413,222**	10,228,433	9,434,420
Less: allowance for loan losses	**(149,017)**	(149,002)	(156,635)
Loans, net	**10,264,205**	10,079,431	9,277,785
Bank premises and equipment, less accumulated depreciation of $144,515 (2005), $142,384 (December 2004) and $154,468 (March 2004)	**141,135**	139,946	141,482
Other real estate owned, net	**145**	212	134
Goodwill	**507,791**	507,791	522,226
Other intangible assets, net (Note 7)	**46,122**	48,226	54,223
Other assets	**484,641**	465,080	424,890
Total assets	**$ 14,627,833**	$ 14,425,690	$ 14,142,382
LIABILITIES			
Deposits:			
Noninterest-bearing deposits	**$ 3,098,666**	$ 3,049,031	$ 2,769,189
Interest-bearing deposits	**7,872,610**	7,750,168	7,774,398
Total deposits	**10,971,276**	10,799,199	10,543,587
Short-term borrowings	**856,963**	887,857	904,327
Accrued expenses and other liabilities	**179,747**	129,996	149,052
Long-term debt	**681,331**	690,955	657,411
Total liabilities	**12,689,317**	12,508,007	12,254,377
COMMITMENTS and CONTINGENCIES (Note 6)			
SHAREHOLDERS EQUITY			
Preferred stock, no par value; authorized 2,000,000 shares; issued and outstanding - None			
Common stock, $2 par value; authorized 130,000,000 shares; issued shares - 79,485,853 (2005), 79,300,506 (December 2004) and 79,974,797 (March 2004); restricted shares - 168,930 (2005), 143,528 (December 2004) and 140,167 (March 2004)	**158,972**	158,601	159,950
Capital surplus	**538,075**	530,705	553,955
Retained earnings	**1,264,634**	1,231,102	1,139,360
Accumulated other comprehensive income (loss)	**(23,165)**	(2,725)	34,740
Total shareholders equity	**1,938,516**	1,917,683	1,888,005
Total liabilities and shareholders equity	**$ 14,627,833**	$ 14,425,690	$ 14,142,382

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CONSOLIDATED INCOME

(Dollars in thousands, except per share data)	For the 3 months ended March 31, 2005		2004	
INTEREST INCOME				
Interest and fees on loans	**$**	**152,544**	$	129,129
Interest and dividends on investment securities:				
Taxable interest income		**24,992**		27,401
Tax-exempt interest income		**721**		877
Other investment income		**644**		333
Total interest and dividends on investment securities		**26,357**		28,611
Other interest income		**344**		106
Total interest income		**179,245**		157,846
INTEREST EXPENSE				
Interest on deposits		**25,305**		20,767
Interest on short-term borrowings		**4,042**		1,419
Interest on long-term debt		**6,815**		5,255
Total interest expense		**36,162**		27,441
NET INTEREST INCOME		**143,083**		130,405
Provision for loan losses		**756**		2,426
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES		**142,327**		127,979
NONINTEREST INCOME				
Investment and wealth management		**24,057**		21,983
Service charges on deposit accounts		**10,426**		10,692
Mortgage banking-related fees		**2,283**		2,940
Investment securities gains and (losses), net		**414**		(55)
Nonmarketable investments		**5,271**		4,204
Other income		**15,418**		13,390
Total noninterest income		**57,869**		53,154
NONINTEREST EXPENSES				
Salaries		**46,554**		44,788
Employee benefits		**11,897**		12,513
Net occupancy expense of bank premises		**6,922**		6,060
Furniture and equipment expenses		**7,279**		7,364
Communications and supplies		**4,040**		4,304
Other expenses		**23,461**		18,357
Total noninterest expenses		**100,153**		93,386
Income before income taxes		**100,043**		87,747
Applicable income taxes		**37,416**		32,050
NET INCOME	**$**	**62,627**	$	55,697
NET INCOME PER SHARE OF COMMON STOCK (Note 3):				
Basic	**$**	**0.79**	$	0.70
Diluted	**$**	**0.78**	$	0.69
DIVIDENDS PAID PER COMMON SHARE	**$**	**0.35**	$	0.33

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CHANGES IN CONSOLIDATED SHAREHOLDERS EQUITY

For the 3 months ended March 31, 2005 and 2004

(Dollars in thousands, except per share data)	Total	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
BALANCE, DECEMBER 31, 2003	$ 1,841,441	$ 159,545	$ 548,664	$ 1,110,748	$ 22,484
Net income	55,697			55,697	
Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes	12,256				12,256
Comprehensive income	67,953				
Cash dividends paid:					
Common stock ($.33 per share)	(26,335)			(26,335)	
Issuance of 31,674 shares for dividend reinvestment and stock purchase plan	1,298	63	1,235		
Issuance of 5,873 shares for employee stock purchase dividend reinvestment plan	257	12	245		
Issuance of 138,251 shares for employee stock option plan	2,431	277	2,154		
Restricted stock awards					
Issuance of 26,294 shares	1,199	53	1,146		
Deferred compensation	(1,263)			(1,263)	
Amortization	513			513	
Vested stock options	511		511		
BALANCE, MARCH 31, 2004	$ 1,888,005	$ 159,950	$ 553,955	$ 1,139,360	$ 34,740
BALANCE, DECEMBER 31, 2004	$ 1,917,683	$ 158,601	$ 530,705	$ 1,231,102	$ (2,725)
Net income	62,627			62,627	
Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes	(20,440)				(20,440)
Comprehensive income	42,187				
Cash dividends paid:					
Common stock ($.35 per share)	(27,750)			(27,750)	
Issuance of 26,355 shares for dividend reinvestment and stock purchase plan	1,278	53	1,225		
Issuance of 5,441 shares for employee stock purchase dividend reinvestment plan	273	11	262		
Issuance of 115,703 shares for employee stock option plan	1,519	231	1,288		
Directors deferred compensation plan:					
Issuance of 884 shares		2	(2)		
Contribution	202		202		
Dividend			60	(60)	
Restricted stock awards					
Issuance of 36,964 shares	1,890	74	1,816		
Deferred compensation	(1,938)			(1,938)	
Amortization	653			653	

Vested stock options		2,519				2,519				
BALANCE, MARCH 31, 2005	**$**	**1,938,516**	**$**	**158,972**	**$**	**538,075**	**$**	**1,264,634**	**$**	**(23,165)**

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CONSOLIDATED CASH FLOWS

Increase (decrease) in cash and cash equivalents **(Dollars in thousands)**	**For the 3 months ended March 31,** **2005**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 62,627**	$ 55,697
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**756**	2,426
Depreciation	**3,714**	3,900
Amortization of other intangible assets	**2,072**	2,032
Investment securities (gains) / losses	**(414)**	55
Income of investments in private equity funds	**(2,181)**	(141)
Write-downs of other real estate owned	**1**	
Gains on sales of other real estate owned	**(125)**	(13)
Gains on sales of premises	**(1,147)**	(564)
Net (increase) decrease in assets:		
Interest receivable	**(5,796)**	(1,939)
Other receivables	**363**	2,991
Bank-owned life insurance	**(951)**	(794)
Other assets	**(6,615)**	(11,126)
Loans held-for-sale	**(13,341)**	(23,816)
Net increase (decrease) in liabilities:		
Interest payable	**8,268**	6,052
Accrued expenses	**19,969**	(25,110)
Taxes payable	**24,441**	37,273
Net cash provided by operating activities	**91,641**	46,923
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities of investment securities held-to-maturity	**472**	1,658
Proceeds from maturities of investment securities available-for-sale	**219,959**	297,156
Proceeds from sales of investment securities available-for-sale	**15,997**	8
Purchases of investment securities held-to-maturity		(4,765)
Purchases of investment securities available-for-sale	**(167,201)**	(244,497)
Net increase in customer loans	**(185,665)**	(163,394)
Proceeds from sales of other real estate owned	**191**	75
Capital expenditures	**(5,619)**	(702)
Proceeds from sales of premises	**2,075**	1,169
Purchases of private equity funds	**(1,458)**	(183)
Net cash used in investing activities	**(121,249)**	(113,475)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in noninterest-bearing deposits	**49,635**	18,468
Net increase in checking plus interest and savings accounts	**38,811**	268,332
Net increase (decrease) in certificates of deposit	**83,631**	(5,766)
Net (decrease) increase in short-term borrowings	**(30,894)**	95,306
Repayment of long-term debt	**(1)**	(12)
Proceeds from issuance of shares	**3,070**	3,986
Dividends paid	**(27,750)**	(26,335)
Net cash provided by financing activities	**116,502**	353,979
Net increase in cash and cash equivalents	**86,894**	287,427
Cash and cash equivalents at beginning of period	**245,134**	362,701
Cash and cash equivalents at end of period	**$ 332,028**	$ 650,128
SUPPLEMENTAL INFORMATION		
Cash payments for interest	**$ 27,894**	$ 21,389
Cash payments for income taxes	**13,226**	2,579

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

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

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

2. Business Combinations / Restructuring

The following provides information concerning acquisitions and restructurings. Acquisitions are accounted for as purchases with the results of their operations subsequent to the acquisition date to be included in Bankshares Statements of Consolidated Income.

In 2004, Bankshares initiated a significant reorganization within its Community Banking network. In a move designed to create banks of sufficient size and depth to compete more effectively today and in the future, Bankshares combined 11 affiliate banks to create four new organizations, all with a more prominent Mercantile identity. This reorganization has enabled Bankshares to operate more effectively and efficiently in the face of increased competitive and regulatory pressures. Fewer, larger banks allow better leverage of our branch network, reduce administrative and operational redundancies and increase the breadth and depth of expertise within our Community Banks. All banks that were combined are geographically contiguous, share increasingly common market dynamics and offer the opportunity to create scale efficiencies. In 2004, Bankshares accrued approximately $2.3 million in restructuring charges due to this reorganization. The majority of these costs were in severance charges. At March 31, 2005, $1.4 million remains to be paid.

On January 25, 2005, Bankshares, Mercantile-Safe Deposit and Trust Company, a wholly owned subsidiary of Bankshares and a Maryland Bank (MSD&T), and Community Bank of Northern Virginia, a Virginia Bank (CBNV) entered into an Agreement and Plan of Merger. At December 31, 2004, CBNV had $880 million in assets, $654 million in gross loans and $649 million in deposits. The merger, which is subject to CBNV shareholder approval and certain bank regulatory approvals, among other conditions, is expected to be completed by the end of the second quarter of 2005. CBNV will hold a special meeting of shareholders of CBNV on May 16, 2005, to approve the merger. For the quarter ended March 31, 2005, Bankshares expensed merger-related costs totaling $0.3 million. These costs were included in noninterest expenses.

At the effective time and as a result of the Merger, each outstanding share of CBNV s common stock (the Bank Shares) will be converted into the right to receive either (i) $20.375 in cash without interest (the Cash Election Price), or (ii) .4005 of Bankshares common stock (the Exchange Ratio, and together with the cash Election Price, the Merger Consideration). Each shareholder of CBNV will be entitled to elect the number of its Bank Shares to be exchanged for the Cash Election Price or to make no election, subject to a proration which will provide that the aggregate Merger Consideration exchanged for Bank Shares outstanding at the closing of the Merger will be allocated as 40% cash and 60% Bankshares common stock. The Merger is anticipated to be tax free to the shareholders of CBNV, as to the portion of the Merger Consideration received as Bankshares common stock. Outstanding CBNV stock options will be converted into stock options of Bankshares.

3. Earnings Per Share

Basic earnings per share (EPS) are computed by dividing income available to common shareholders by weighted average common shares outstanding. Diluted EPS are computed using the same components as basic EPS with the denominator adjusted for the dilutive effect of stock options, restricted stock awards and vested directors deferred compensation plan shares. The following tables provide reconciliation between the computation of basic EPS and diluted EPS for the three months ended March 31, 2005 and 2004, respectively.

	For the 3 months ended March 31,				
2005 (In thousands, except per share data)		**Net Income**	**Weighted Average Common Shares**		**EPS**
Basic EPS	**$**	**62,627**	**79,228**	**$**	**0.79**
Dilutive effect of:					
Stock options and restricted stock awards			**479**		
Vested directors deferred compensation plan shares			**168**		
Diluted EPS	**$**	**62,627**	**79,875**	**$**	**0.78**

	For the 3 months ended March 31,				
2004 (In thousands, except per share data)		**Net Income**	**Weighted Average Common Shares**		**EPS**
Basic EPS	$	55,697	79,725	$	0.70
Dilutive effect of:					
Stock options and restricted stock awards			533		
Diluted EPS	$	55,697	80,258	$	0.69

Antidilutive options and awards excluded from the computation of diluted earnings per share were 116,565 and 298,319 for the three months ended March 31, 2005 and 2004, respectively.

4. Investment Securities

At both periods presented, securities with an amortized cost of $1.1 billion were pledged as collateral for certain deposits as required.

The amortized cost and fair value of investment securities at March 31, 2005 and December 31, 2004 are shown below:

	March 31, 2005				December 31, 2004			
(Dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Investment securities held-to-maturity								
States and political subdivisions	**$ 19,704**	**$ 683**	**$ 16**	**$ 20,371**	$ 20,176	$ 921	$ 3	$ 21,094
Investment securities available-for-sale								
U.S. Treasury	**$ 521,307**	**$ 1,511**	**$ 2,487**	**$ 520,331**	$ 605,505	$ 4,534	$ 980	$ 609,059
U.S. Government agencies	**875,677**	**1,329**	**11,246**	**865,760**	853,930	3,742	4,699	852,973
Mortgage-backed securities	**1,326,104**	**1,322**	**28,148**	**1,299,278**	1,326,056	4,372	13,127	1,317,301
States and political subdivisions	**60,405**	**433**	**88**	**60,750**	61,984	917	31	62,870
Other investments	**60,969**	**851**	**218**	**61,602**	65,323	1,294	126	66,491
Total	**$ 2,844,462**	**$ 5,446**	**$ 42,187**	**$ 2,807,721**	$ 2,912,798	$ 14,859	$ 18,963	$ 2,908,694

At March 31, 2005, there were $328.3 million of individual securities that had unrealized losses for a period greater than 12 months. At March 31, 2005, these securities had an unrealized loss of $14.8 million of which 93.4% were mortgage-backed securities. Management has assessed the impairment of these securities and determined that the impairment is temporary. All principal and interest payments on available-for-sale debt securities in an unrealized loss position for greater than 12 months are expected to be collected given the high credit quality of the U.S. government agency debt securities and Bankshares ability and intent to hold the securities until such time as the value recovers or they mature.

5. Impaired Loans

When scheduled principal or interest payments are past due 90 days or more at quarter-end on any loan, the accrual of interest income is discontinued and subsequent receipts on these loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Previously accrued but uncollected interest on these loans is charged against interest income. Generally, a loan may be restored to accruing status when all past due principal, interest and late charges have been paid and the bank expects repayment of the remaining contractual principal and interest on a timely basis.

Under Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, Accounting by Creditors for Impairment of a Loan-an amendment of FASB Statements Nos. 5 and 15, a loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. Information with respect to impaired loans and the related valuation allowance (if the measure of the impaired loan is less than the recorded investment) at March 31, 2005, December 31, 2004 and March 31, 2004 is shown below. See Annual Report on Form 10-K for more detail.

(Dollars in thousands)		**March 31, 2005**		**December 31, 2004**		**March 31, 2004**
Impaired loans with a specific valuation allowance	**$**	**17,188**	$	18,365	$	25,971
All other impaired loans		**11,592**		9,113		16,508
Total impaired loans	**$**	**28,780**	$	27,478	$	42,479
Specific allowance for loan losses applicable to impaired loans	**$**	**10,437**	$	10,611	$	14,094
General allowance for loan losses applicable to other than impaired loans		**138,580**		138,391		142,541
Total allowance for loan losses	**$**	**149,017**	$	149,002	$	156,635
Year-to-date interest income on impaired loans recorded on the cash basis	**$**	**23**	$	379	$	103
Year-to-date average recorded investment in impaired loans during the period	**$**	**28,780**	$	39,025	$	42,479
Quarter-to-date interest income on impaired loans recorded on the cash basis	**$**	**23**	$	79	$	103
Quarter-to-date average recorded investment in impaired loans during the period	**$**	**28,780**	$	35,583	$	42,479

Note: Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The allowance for loan losses related to these loans is included in the general allowance for loan losses applicable to other than impaired loans.

6. Commitments and Contingencies

Bankshares is a party to financial instruments that are not reflected in the balance sheet, which include commitments to extend credit and standby letters of credit. Various commitments to extend credit (lines of credit) are made in the normal course of banking business. Letters of credit are issued for the benefit of customers by affiliated banks. These commitments are subject to loan underwriting standards and geographic boundaries consistent with Bankshares loans outstanding. Bankshares lending activities are concentrated in Maryland, Delaware and Virginia.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Total commitments to extend credit were $4.4 billion at March 31, 2005, $4.2 billion at December 31, 2004, and $3.6 billion at

March 31, 2004.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party. Outstanding letters of credit were $401.7 million at March 31, 2005, $379.8 million at December 31, 2004 and $303.3 million at March 31, 2004. Fees received for issuing letters of credit are deferred and amortized over the life of the commitment. The unamortized fees on letters of credit at March 31, 2005, December 31, 2004, and March 31, 2004 had a carrying value of $1.4 million, $1.3 million and $1.1 million, respectively.

Bankshares mortgage banking subsidiary is a Fannie Mae Delegated Underwriting and Servicing lender, and has a loss sharing arrangement for loans originated on behalf of and sold to Fannie Mae. The unamortized principal balance of the underlying loans totaled $220.9 million, $190.7 million and $148.6 million at March 31, 2005, December 31, 2004 and March 31, 2004, respectively. No loss reserve has been established for potential losses on loans originated and sold in the secondary market since there have been no losses recognized during the history of this arrangement and no losses were incurred at March 31, 2005. The mortgage subsidiary also has originated and sold loans with recourse in the event of foreclosure on the underlying real estate. The unamortized amount of principal balance of loans sold with recourse totaled $1.6 million at March 31, 2005, $1.7 million at December 31, 2004 and $2.2 million at March 31, 2004. These mortgages are generally in good standing, are well-collateralized and no loss has ensued and no future loss is expected.

Bankshares has committed to invest funds in third-party private equity investments. At March 31, 2005, December 31, 2004 and March 31, 2004, $32.5 million, $28.9 million and $20.9 million, respectively, remained unfunded.

In the ordinary course of business, Bankshares and its subsidiaries are involved in a number of pending and threatened legal actions and proceedings. In certain of these actions and proceedings, claims for substantial monetary damages are asserted against Bankshares and its subsidiaries. In view of the inherent difficulty of predicting the outcome of such matters, Bankshares cannot state what the eventual outcome of pending matters will be. However, based on current knowledge, management does not believe that liabilities, if any, arising from pending litigation matters, will have a material adverse effect on the consolidated financial position or liquidity of Bankshares. If payment associated with a claim becomes probable and the cost can be reasonably estimated, a contingent liability would be established based on information currently available, advice of counsel and available insurance coverage.

As previously disclosed, on July 12, 2004, former employee John Pileggi filed a lawsuit against Mercantile Bankshares Corporation (Bankshares), Mercantile-Safe Deposit and Trust Company (MSD&T) and Edward J. Kelly, III, Chairman and CEO of Bankshares alleging that the public statements made by the defendants regarding the circumstances of Mr. Pileggi s termination gave rise to claims of libel, invasion of privacy and false light. Mr. Pileggi also alleged breach of his employment contract and made a claim pursuant to a change-in-control agreement. The complaint sought actual and punitive damages amounting to in excess of $240 million.

On September 27, 2004, Bankshares filed a countersuit against Mr. Pileggi alleging that during his employment, Mr. Pileggi engaged in activities that constituted fraud, breach of contract, and breach of his fiduciary duty. The countersuit sought compensatory and punitive damages amounting to $8.2 million.

On March 30, 2005, Bankshares, MSD&T, Mr. Kelly and Mr. Pileggi agreed to dismiss all claims and provide full releases from any future claims. In addition, Mercantile has agreed to pay Mr. Pileggi $1.3 million in respect of Mr. Pileggi s employment contract and certain related benefits. Mercantile also has agreed, subject to certain conditions, to pay a portion of the legal fees incurred by Mr. Pileggi.

7. Other Intangible Assets

The following table discloses the gross carrying amount and accumulated amortization of intangible assets subject to amortization at March 31, 2005 and December 31, 2004:

	March 31, 2005	December 31, 2004
(Dollars in thousands)		

	Gross carrying amount	Accumulated amortization	Net amount	Gross carrying amount	Accumulated amortization	Net amount
Core deposits	**$ 49,881**	**$ (16,380)**	**$ 33,501**	$ 49,881	$ (15,014)	$ 34,867
Mortgage servicing	**1,338**	**(1,072)**	**266**	1,370	(1,013)	357
Customer lists and other	**17,010**	**(4,655)**	**12,355**	17,010	(4,008)	13,002
Total	**$ 68,229**	**$ (22,107)**	**$ 46,122**	$ 68,261	$ (20,035)	$ 48,226

Identifiable intangible assets are amortized based on estimated lives of up to 15 years. Management reviews other intangible assets for impairment yearly, or whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. For those intangible assets subject to amortization, impairment is indicated if the sum of undiscounted estimated future net cash flows is less than the carrying amount of the asset. Impairment is recognized by writing down the carrying value or adjusting the estimated life of the asset. Any impairment recognized in a valuation account is reflected in the income statement in the corresponding period.

The following table shows the current period and estimated future amortization expense for amortized intangible assets. The projections of amortization expense shown for mortgage servicing rights are based on asset balances and the interest rate environment as of March 31, 2005. Future amortization expense may be significantly different depending upon changes in the mortgage servicing portfolio, mortgage interest rates and market conditions.

(Dollars in thousands)		Core deposits	Mortgage servicing	Customer lists and other	Total
Three months ended March 31, 2005 (actual)		**$ 1,367**	**$ 54**	**$ 651**	**$ 2,072**
Nine months ended December 31, 2005 (estimated)		4,100	74	1,939	6,113
Twelve months ended December 31, 2005 (estimated)		5,467	128	2,590	8,185
Estimate for year ended December 31,	2006	5,467	99	2,343	7,909
	2007	5,209	39	2,149	7,397
	2008	4,344		1,966	6,310
	2009	4,020		1,028	5,048

8. Comprehensive Income

The following table summarizes the market value change and related tax effect of unrealized gains (losses) on securities available-for-sale for the quarters ended March 31, 2005 and 2004, respectively. The total comprehensive income is included in the Statements of Changes in Consolidated Shareholders Equity.

(Dollars in thousands)	For the 3 months ended March 31, 2005	2004
Net income	**$ 62,627**	$ 55,697
Other comprehensive income, net of taxes:		
Unrealized holding (losses) gains arising during the period	**(20,190)**	12,223
Reclassification adjustment for (gains) losses included in net income	**(250)**	33
Total	**$ 42,187**	$ 67,953

9. Capital Adequacy

Bankshares and its bank affiliates are subject to various regulatory capital adequacy requirements administered by federal and state banking agencies. These requirements include maintaining certain capital ratios above minimum levels. These capital ratios include tier I capital and total risk-based capital as percentages of net risk-weighted assets and tier I capital as a percentage of adjusted average total assets (leverage ratio). The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00%, for the tier I capital, total capital and leverage ratios, respectively. To be categorized as *well capitalized,* a bank must maintain minimum ratios of 6.00%, 10.00% and 5.00%, for its tier I capital, total capital and leverage ratios, respectively. As of March 31, 2005, Bankshares and each of its bank affiliates exceeded all capital adequacy requirements to be considered well capitalized.

Capital ratios and the amounts used to calculate them are presented in the following table for Bankshares and Mercantile-Safe Deposit and Trust Company (MSD&T), the lead bank, as of March 31, 2005 and December 31, 2004.

(Dollars in thousands)	March 31, 2005 Bankshares	MSD&T	December 31, 2004 Bankshares	MSD&T
Tier I capital	**$ 1,412,974**	**$ 419,288**	$ 1,370,112	$ 411,587

Total risk-based capital	**1,844,629**	**467,357**	1,802,520	459,812
Net risk-weighted assets	**11,323,077**	**3,839,217**	11,109,137	3,847,161
Adjusted average total assets	**13,873,772**	**4,669,943**	13,674,386	4,504,451
Tier I capital ratio	**12.48%**	**10.92%**	12.33%	10.70%
Total capital ratio	**16.29%**	**12.17%**	16.23%	11.95%
Leverage ratio	**10.18%**	**8.98%**	10.02%	9.14%

Bankshares has an ongoing share repurchase program. Purchases may be made from time to time, subject to regulatory requirements, in open market or in privately negotiated transactions. Purchased shares are retired. At March 31, 2005, there were 476,327 shares remaining available for repurchase under the plan.

10. Segment Reporting

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

The following tables present selected segment information for the three months ended March 31, 2005 and 2004. The components in the Other column consist of amounts for the nonbank affiliates, unallocated corporate expenses including income taxes and intercompany eliminations. Certain expense amounts such as operations overhead have been reclassified from internal financial reporting in order to provide for full cost absorption. These reclassifications are shown in the Adjustments line.

	For the 3 months ended March 31, 2005			
(Dollars in thousands)	**Banking**	**IWM**	**Other**	**Total**
Net interest income	**$ 143,094**	**$**	**$ (11)**	**$ 143,083**
Provision for loan losses	**(756)**			**(756)**
Noninterest income	**29,491**	**24,313**	**4,065**	**57,869**
Noninterest expenses	**(80,451)**	**(16,846)**	**(2,856)**	**(100,153)**
Adjustments	**3,929**	**(1,209)**	**(2,720)**	
Income (loss) before income taxes	**95,307**	**6,258**	**(1,522)**	**100,043**
Income tax (expense) benefit	**(33,047)**	**(2,506)**	**(1,863)**	**(37,416)**
Net income (loss)	**$ 62,260**	**$ 3,752**	**$ (3,385)**	**$ 62,627**
Average loans	**$ 10,313,937**		**$ 424**	**$ 10,314,361**
Average earning assets	**13,199,433**		**21,734**	**13,221,167**
Average assets	**14,348,599**		**159,745**	**14,508,344**
Average deposits	**10,903,318**		**(184,584)**	**10,718,734**
Average equity	**1,805,588**		**144,688**	**1,950,276**

	For the 3 months ended March 31, 2004			
(Dollars in thousands)	**Banking**	**IWM**	**Other**	**Total**
Net interest income	$ 130,345	$	$ 60	$ 130,405
Provision for loan losses	(2,426)			(2,426)
Noninterest income	27,095	22,382	3,677	53,154
Noninterest expenses	(75,527)	(17,379)	(480)	(93,386)
Adjustments	3,231	(796)	(2,435)	
Income (loss) before income taxes	82,718	4,207	822	87,747
Income tax (expense) benefit	(29,046)	(1,683)	(1,321)	(32,050)
Net income (loss)	$ 53,672	$ 2,524	$ (499)	$ 55,697
Average loans	$ 9,338,236		$ 197	$ 9,338,433
Average earning assets	12,348,307		23,886	12,372,193
Average assets	13,069,701		548,492	13,618,193
Average deposits	10,138,846		(72,201)	10,066,645
Average equity	1,373,147		475,314	1,848,461

11. Derivative Instruments and Hedging Activities

FASB Statement No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities,* FASB Statement No. 138 (SFAS No. 138), *Accounting for Certain Derivative Instruments and Certain Hedging Activities an amendment to FASB Statement No. 133* and FASB Statement No. 149 (SFAS No. 149), *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities* (collectively referred to as derivatives), establishes accounting and reporting standards for derivative instruments and for hedging activities. Bankshares maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. Currently, derivative instruments that are used as part of the interest rate risk management strategy have been restricted to interest rate swaps. Interest rate swaps generally involve the exchange of fixed-rate and variable-rate interest payments between two parties, based on a common notional principal amount and maturity date. As of March 31, 2005, Bankshares has interest rate swaps to convert a portion of its nonprepayable fixed-rate debt to floating-rate debt. Bankshares also arranges interest rate swaps, caps and swaptions for commercial loan customers through its capital markets group. Derivative transactions done with loan customers are hedged by means of an off-setting derivative trade with a third party. In this way, Bankshares manages the market risk arising from capital markets related derivative activity.

The fair value of derivative instruments relating to hedging activities recorded in other assets was $1.6 million (notional $261.2 million) and $7.1 million (notional $294.5 million) at March 31, 2005 and December 31, 2004, respectively. The fair value of derivative instruments relating to hedging activities recorded in other liabilities was $10.0 million (notional $175.7 million) and $6.8 million (notional $136.0 million) at March 31, 2005 and December 31, 2004, respectively.

Changes in the fair value of a derivative that is designated and qualifies as a fair value hedge, along with the gain or loss on the hedged asset or liability that is attributable to the hedged risk, are recorded as other noninterest income in the results of operations. For all hedge relationships, ineffectiveness resulting from differences between the changes in fair values or cash flows of the hedged item and changes in fair value of the derivative are recognized as other noninterest income in the results of operations. The net interest settlement on derivatives designated as fair value or cash flow hedges is treated as an adjustment of the interest income or interest expense of the hedged assets or liabilities. The fair-value hedges of nonprepayable fixed-rate debt were effective for the reported periods. The impact of the hedges decreased interest expense $1.6 million in the first three months of 2005 and $2.8 million for the same period in 2004.

The following tables summarize the gross position of derivatives relating to hedging activities at March 31, 2005 and December 31, 2004:

	March 31, 2005			December 31, 2004		
(Dollars in thousands)	**Notional or Contractual Amount**	**Credit Risk Amount (1)**	**Estimated Net Fair Value**	**Notional or Contractual Amount**	**Credit Risk Amount (1)**	**Estimated Net Fair Value**
Asset/Liability Management Hedges						
Interest Rate Contracts:						
Swaps	**$ 350,000**	**$ 4,082**	**$ (9,021)**	$ 350,000	$ 6,297	$ (143)
Customer Accommodations						
Interest Rate Contracts:						
Swaps	**$ 75,024**	**$ 826**	**$ 632**	$ 68,575	$ 684	$ 398
Swaptions/Caps Purchased	**5,941**	**68**	**68**	5,971	80	80
Swaptions/Caps Sold	**5,941**		**(68)**	5,971		(80)

(1) Credit risk amounts reflect the replacement cost for those contracts in a gain position in the event of nonperformance by all counterparties.

Mortgage loans held-for-sale have inherent forward contract (agreements to sell or purchase loans at a specific rate or yield) characteristics. Risk may arise from the corresponding parties inability to meet the terms of their contracts and from movement in interest rates. Bankshares has forward commitments to sell and fund individual fixed-rate and variable-rate mortgage loans that are reported at fair value. The fair value of the forward contracts was $1.5 million at March 31, 2005 and $1.2 million at December 31, 2004.

12. Stock-based Compensation Expense

Bankshares has several stock-based compensation programs for its directors, management and employees. Compensation costs for stock options and restricted stock awards are measured under the fair value method and are included in salary expense. Another form of stock-based compensation is phantom stock, which is used for a portion of the Bankshares Directors Deferred Compensation Plan. This plan requires that substantially all deferred fees be settled in Bankshares stock. The compensation cost for the phantom stock is included in other expenses. Employee stock-based compensation amounts, included in salaries expense, for the quarters ended March 31, 2005 and 2004, respectively, are summarized in the following table:

	For the 3 months ended March 31	
(Dollars in thousands)	**2005**	**2004**
Stock options expense	**$ 713**	$ 406
Restricted stock awards expense	**642**	487
Included in salaries expense	**$ 1,355**	$ 893

13. Pension & Other Postretirement Benefit Plans

Bankshares sponsors qualified and nonqualified pension plans and other postretirement benefit plans for its employees. The following table summarizes the components of the net periodic benefit cost for the pension plans for the three months ended March 31, 2005 and 2004, respectively.

	For the 3 months ended March 31, 2005			For the 3 months ended March 31, 2004		
(Dollars in thousands)	**Qualified**	**Nonqualified**	**Total**	**Qualified**	**Nonqualified**	**Total**
Service cost	**$ 1,778**	**$ 165**	**$ 1,943**	$ 1,572	$ 141	$ 1,713
Interest cost	**2,813**	**35**	**2,848**	2,549	101	2,650
Expected return on plan assets	**(4,138)**		**(4,138)**	(3,845)		(3,845)
Amortization of prior service cost	**300**		**300**	195	6	201
Recognized net actuarial (gain) loss	**350**		**350**	153	29	182
Amortization of transition asset					24	24
Net periodic benefit cost	**$ 1,103**	**$ 200**	**$ 1,303**	$ 624	$ 301	$ 925

The following table summarizes the components of the net periodic benefit cost for the other postretirement benefit plans for the three months ended March 31, 2005 and 2004, respectively.

	For the 3 months ended March 31,	
(Dollars in thousands)	**2005**	**2004**
Service cost	**$ 133**	$ 65
Interest cost	**249**	214
Expected return on plan assets		
Amortization of prior service cost		
Recognized net actuarial (gain) loss	**88**	38

Amortization of transition asset				
Net periodic benefit cost	**$**	**470**	$	317

As previously disclosed in its financial statements for the year ended December 31, 2004, Bankshares generally makes cash contributions to the pension plan in amounts up to that permitted by guidelines established under employee benefit and tax laws after taking into consideration the funded status. If it is determined that there will be cash contributions, they are normally made after valuations have been finalized for the plan year and prior to the tax return filing date. Bankshares does not anticipate making a contribution in 2005.

14. Recent Accounting Standards

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, which addresses the accounting for differences between contractual cash flows and expected cash flows for loans acquired in a transfer when those differences are attributable at least in part to credit quality. It includes such loans acquired in purchase business combinations where there is evidence of deterioration in credit quality since origination. This SOP requires the difference between expected cash flows and the purchase price to be accreted as an adjustment to yield over the life of the acquired loans; the difference between contractual cash flows and expected cash flows is not subject to accretion. This SOP would represent a change from past practice where the allowance for loan losses was carried over in purchase accounting. The SOP is effective for loans acquired after December 15, 2004. Bankshares will utilize this SOP in evaluating the impact it will have on operations and financial statements with respect to Community Bank of Northern Virginia and will apply this SOP to any new acquisitions.

In November 2004, the Emerging Issues Task Force (EITF) published Issue 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The Task Force discussed the meaning of other-than-temporary impairment and its application to certain investments carried at cost. The Task Force requested that the FASB staff consider other impairment models within U.S. GAAP when developing its views. The Task Force also requested that the scope of the impairment issue be expanded to include equity investments and investments subject to FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, and that that issue be addressed by the Task Force as a separate EITF issue. At the EITF meeting, the Task Force reached a consensus on one issue that certain quantitative and qualitative disclosures should be required for securities accounted for under Statement 115 that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The Board ratified the consensus on that one issue at its November 25, 2004 meeting. In September 2004, the Financial Accounting Standards Board (FASB) directed the FASB staff to issue two proposed FASB Staff Positions (FSP): Proposed FSP EITF Issue 03-1-a, which provides guidance for the application of paragraph 16 of EITF Issue 03-1 to debt securities that are impaired because of interest rate and/or sector spread increases, and Proposed FSP EITF Issue 03-1-b, which delays the effective date of Issue 03-1 for debt securities that are impaired because of interest rate and/or sector spread increases. The outcome of the proposed guidance under certain interpretations could have an adverse impact on Bankshares capital and earnings as it relates to securities deemed impaired within the available-for-sale investment portfolio. Bankshares cannot determine the potential impact until the FASB finalizes the proposed statement.

In December 2004, the FASB issued Statement No. 123 (Revised 2004) SFAS No. 123R, Share-Based Payment, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123R replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123 permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the Notes to the financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Bankshares adopted the cost recognition provision of SFAS No. 123, Accounting for Stock-Based Compensation, in 1995 and has been expensing compensation cost related to stock options. Bankshares does not anticipate this revision will have a material effect on the financial statements. On April 14, 2005, the Securities and Exchange Commission (SEC) approved a new rule that delays for public companies the effective date of SFAS No. 123R. Under the SEC s rule SFAS, No. 123R is now effective for annual periods that begin after June 15, 2005.

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

MERCANTILE BANKSHARES CORPORATION

HIGHLIGHTS

Consolidated Financial Results

Net income for the quarter ended March 31, 2005 was $62.6 million, a 12.4% increase from net income of $55.7 million for the same period in 2004 and a 3.3% increase over the $60.6 million reported for the fourth quarter of 2004. For the quarter ended March 31, 2005, diluted net income per share was $.78, an increase of 13.0% from the $.69 reported for the same period of last year and an increase of 2.6% from the $.76 reported for the fourth quarter of last year. Adjusted weighted average shares outstanding decreased from 80.3 million for the quarter ended March 31, 2004, to 79.9 million for the quarter ended March 31, 2005.

Net interest income for the quarter ended March 31, 2005 increased 9.7% to $143.1 million from $130.4 million for the first quarter of last year. The growth in net interest income was attributable to a 10.5% growth in average loans and a 14 basis point improvement in the net interest margin. Loan growth was solid in all categories, except for consumer loans which were up only slightly. The strongest growth was in average construction loans, which increased 20.4%. Twelve basis points of the improvement in the net interest margin was attributable to the effect of noninterest-bearing funds, which consist primarily of demand deposits and shareholders equity.

At March 31, 2005, nonperforming assets amounted to $31.4 million or 0.30% of period-end loans and other real estate owned, a decline from $48.1 million at March 31, 2004. Nonperforming assets were $31.1 million at December 31, 2004. The comparable nonperforming asset ratios were 0.51% and 0.30% at March 31, 2004 and December 31, 2004, respectively. The level of monitored loans, or loans with characteristics suggesting that they could be classified as nonperforming in the near future, amounted to $2.2 million at March 31, 2005. Monitored loans were $26.6 million at March 31, 2004 and $6.4 million at December 31, 2004. Nonperforming loans as a percentage of total loans remain at historic low levels.

Noninterest income, which includes investment and wealth management fees, service charges on deposit accounts, mortgage banking-related fees, securities gains and losses, nonmarketable investments income and other income, increased 8.9% to $57.9 million for the first quarter of 2005 from $53.2 million for the first quarter of 2004.

Noninterest expenses, which include salaries, employee benefits, net occupancy expense of bank premises, furniture and equipment expenses, communications and supplies and other expenses, increased by 7.2% for the quarter ended March 31, 2005 to $100.2 million from $93.4 million for the first quarter of 2004.

Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities operations into Bankshares) unrelated to Bankshares core operations. Cash operating earnings totaled $63.1 million for the first quarter of 2005, an increase of 11.1% over the $56.8 million for the same period for 2004 and a 1.4% increase over the $62.2 million for the fourth quarter of 2004. Diluted cash operating earnings per share for the first quarter of 2005 and 2004 were $.79 and $.71, respectively, and $.78 per share for the fourth quarter of 2004. A reconciliation of net income (GAAP basis) to cash operating earnings can be found on page 34 of this filing.

Management believes that reporting several key measures based on cash operating earnings and tangible equity (equity less intangible assets and their related amortization expense) is important, as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes. For the three months ended March 31, 2005, return on average assets was 1.75%, return on average tangible equity was 18.57% and average tangible equity to average tangible assets was 10.00%. Comparable ratios for the three months ended March 31, 2004 were 1.64%, 18.01% and 9.75%, respectively. A reconciliation of these ratios from their respective GAAP basis ratios can be found on page 34 of this filing.

SEGMENT REPORTING

As noted in Note No. 10 Segment Reporting , Bankshares report two business segments - Banking and Investment and Wealth Management (IWM) for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, the financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares consolidated results. Certain expense amounts, such as operations overhead, have been reclassified from internal financial reporting in order to provide for proper allocation of costs in the reported data. A schedule disclosing the details of these operating segments can be found in Note No. 10 of the financial statements.

Banking

The Banking segment consists of 13 affiliate banks. Mortgage banking activities are not viewed as a separate business line due to the insignificant impact on the core business of Bankshares and, accordingly, are included in the Banking segment.

In the second quarter of 2005, Bankshares will consolidate Fidelity Bank into Farmers and Mechanics. The consolidation of these banks allows the surviving banks to serve their local customers with greater size, scale and expertise. Also in the second quarter of 2005, Mercantile Potomac Bank will merge into Mercantile-Safe Deposit and Trust Company. This combination allows Bankshares to provide the resources necessary for the expansion into the Washington D.C. and Northern Virginia markets. The acquisition of Community Bank of Northern Virginia is also expected to occur in the second quarter and become a part of the Mercantile Potomac Division of Mercantile-Safe Deposit and Trust Company. Mercantile Potomac Bank and Fidelity Bank will continue to serve their respective markets under their own names with local leadership and local decision-making. The consolidations of Fidelity Bank into Farmers and Mechanics and Mercantile Potomac Bank into Mercantile-Safe Deposit and Trust Company and are both subject to regulatory approvals.

For the first quarter of 2005 compared with the first quarter of 2004 net income for Banking increased 16.0% to $62.3 million, from $53.7 million. Net interest income for Banking increased 9.8% to $143.1 million for the three months ended March 31, 2005. The growth in net interest income in 2005 reflected a 6.9% increase in average earning assets, and a 14 basis point improvement in the net interest margin from 4.30% at March 31, 2004 to 4.44% at March 31, 2005. The increase in average loan balances of 10.4% for the first quarter of 2005 reflected strong growth in loans related to the real estate market. Commercial real estate loan balances increased 12.8%, residential real estate loan balances increased 11.6% and construction loan balances increased 20.4%. Commercial loan balances also reflected the improved economic environment with a 9.6% growth rate, while consumer loans remained flat and lease financings declined by 29.7%. Average deposits included growth in noninterest-bearing, interest checking, savings accounts and time deposits greater than $100,000, offset by a reduction in balances associated with money market accounts and other time deposits in the first quarter of 2005, compared with the first quarter of 2004. The improvement in the net interest margin was primarily attributable to an 11 basis point improvement in the benefit provided by noninterest-bearing sources of funds.

As a reflection of the overall improvement in the Banking credit quality trends, there was a decrease of $1.7 million in the provision for loan losses for 2005. Banking recorded a provision for loan losses of $0.8 million for the first quarter of 2005 compared with $2.4 million for the same period of 2004. The allowance as a percent of loans was 1.43% at March 31, 2005 compared with 1.46% at December 31, 2004 and 1.66% at March 31, 2004.

Noninterest income increased by $2.4 million, with a gain from the sale of a branch related to the consolidation of overlapping branches of $1.1 million, gains on securities sold of $0.4 million, insurance fees increasing by $0.7 million and electronic banking fees increasing by $0.8 million, accounting for the largest gains. These gains were partially offset by a decrease of $0.8 million in mortgage banking fees and $0.3 million in service charges on deposit accounts. The first quarter growth in fee-based revenue was attributable to increased insurance sales, pricing, increased customer usage of electronic banking products offset by reduced mortgage origination income and cash management analysis fees.

Noninterest expenses were $80.5 million in the first quarter of 2005, compared to $75.5 million for the same period of 2004, an increase of $4.9 million (6.5%). Noninterest expenses net of adjustments were $76.5 million for the first quarter of 2005, compared with $72.3 million for the same period of 2004, a $4.2 million increase (5.8%). The increase in noninterest expenses was primarily attributable to $1.1 million in electronic banking expenses and $0.4 million in insurance commission costs, which were partially offset by the revenues generated by these services. Other increases in noninterest expenses were attributable to personnel expenses of $0.6 million and occupancy costs of $0.5 million. With the outsourcing to Sungard, IWM is no longer reimbursing the Banking segment for previously shared mainframe computer and technology costs, which increased current period expenses.

Investment & Wealth Management

Net income in IWM increased to $3.8 million in 2005, from $2.5 million in 2004. Compared with the fourth quarter of 2004, net income increased 16.8% from $3.3 million.

At March 31, 2005, assets under administration by IWM were $48.0 billion, an increase of $1.5 billion from the first quarter of 2004. Bankshares had investment management responsibility for $21.7 billion, up from $21.4 billion for the same period last year.

Revenues increased $1.9 million, or 8.6% to $24.3 million in 2005 from $22.4 million in the first quarter of 2004. On a linked-quarter basis IWM revenue increased $1.3 million or 5.9% from $23.0 million in the fourth quarter of 2004. Revenue increases were achieved in the three principal client segments: private wealth, institutional and brokerage. Growth in IWM revenues was due to net new business flows, particularly in our institutional business, and to better equity markets. Weaker fixed income markets modestly offset stronger equity markets.

Expenses decreased 3.1% to $16.8 million in 2005. The $1.2 million increase in outsourcing expenses related to the IWM SunGard service contract was offset by a reduction in operation personnel expenses and technology allocations from the Banking segment.

During the first quarter of 2004, Bankshares entered into a seven-year service contract with SunGard Wealth Management Services to provide a new core accounting system and back-office operations that began in January of 2005. Conversion costs of approximately $1.8 million that were incurred in 2004 are being amortized over the life of the contract.

Other

The components in the Other column consist of amounts for the nonbanking affiliates, unallocated corporate expenses and intercompany eliminations.

For the first quarter of 2005 compared to the same period of 2004, noninterest income increased $0.4 million related to income from private equity investments. Noninterest expense increased $2.4 million. This increase is due mostly to $2.1 million in accrued costs, including a $1.3 million settlement, related to the Pileggi litigation matter.

The adjustments line, which represents corporate allocations from the lead Bank (MSD&T), increased $0.3 million in 2005 over the first quarter of 2004.

BANKSHARES EARNINGS PERFORMANCE

Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheet, interest income/expense and annualized yields earned and rates paid through the three months ended March 31, 2005 and 2004.

	2005			2004		
(Dollars in thousands)	**Average Balance (2)**	**Income (1) / Expense**	**Yield (1) / Rate**	**Average Balance (2)**	**Income (1) / Expense**	**Yield (1) / Rate**
Earning assets						
Loans:						
Commercial	**$ 2,848,452**	**$ 41,467**	**5.90%**	$ 2,623,891	$ 33,693	5.16%
Commercial real estate	**3,133,446**	**48,534**	**6.28**	2,777,493	40,656	5.89
Construction	**1,328,633**	**20,451**	**6.24**	1,103,901	14,209	5.18
Residential real estate	**1,517,291**	**21,797**	**5.83**	1,358,975	20,488	6.06
Consumer	**1,486,539**					