

BAY NATIONAL CORP
Form 10KSB
March 30, 2006

**United States
Securities and Exchange Commission
Washington, D.C. 20549**

Form 10-KSB

(Mark One)

**ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 000-51765

Bay National Corporation
(Name of small business issuer in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

52-2176710
(I.R.S. Employer
Identification No.)

2328 West Joppa Road, Lutherville, Maryland 21093
(Address of principal executive offices) (Zip Code)

Issuer's telephone number: 410-494-2580

Securities registered under Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act: Common stock, par value \$0.01 per share

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

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

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Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [x]

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

The issuer's revenues for its most recent fiscal year were \$13,733,299.

The aggregate market value of the common equity held by non-affiliates was \$28,121,276 as of March 23, 2006, based on a sales price of \$20.25 per share of Common Stock, which is the sales price at which shares of Common Stock were last sold in over the counter trading on March 15, 2006.

The number of shares outstanding of the issuer's Common Stock was 1,927,894 as of March 23, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2006 Annual Meeting of Stockholders of Bay National Corporation, to be filed with the Securities and Exchange Commission no later than 120 days after the close of the fiscal year, are incorporated by reference in Part III of this Annual Report on Form 10-KSB.

Transitional Small Business Disclosure Format (check one): Yes No

PART I

Item 1. Description of Business

BUSINESS OF BAY NATIONAL CORPORATION AND BAY NATIONAL BANK

General

Bay National Corporation was incorporated under the laws of the State of Maryland on June 3, 1999, primarily to serve as a bank holding company for a proposed federally chartered commercial bank to be named Bay National Bank.

Bay National Bank commenced operations on May 12, 2000 with its main office in Lutherville, Maryland and a branch office in Salisbury, Maryland. Bay National Bank accepts checking and savings deposits and offers a wide range of commercial and industrial, real estate, consumer and residential mortgage loans.

On December 12, 2005, Bay National Corporation consummated the sale of a trust preferred securities offering in which it issued \$8,248,000 of subordinated debt securities due 2036 to Bay National Capital Trust I, a Delaware statutory trust (the "Trust") and an unconsolidated subsidiary formed by Bay National Corporation, and the Trust simultaneously issued \$8,000,000 of trust preferred securities. The Trust also issued \$248,000 of its common securities to Bay National Corporation. No underwriting commissions were paid in connection with the issuances. All of the securities were issued in a private placement exempt from registration under 4(2) of the Securities Act of 1933, as amended and/or Regulation D promulgated thereunder.

Marketing Focus

Bay National Bank was formed by a group of individuals active in business, professional, banking, financial and charitable activities in the Baltimore, Maryland metropolitan area and the Eastern Shore of Maryland. These individuals believed that the banking needs of certain segments of these communities were not being served adequately by existing banks. Specifically, as a result of bank mergers in the 1990's, many banks in the Baltimore metropolitan area and the Eastern Shore of Maryland became local branches of large regional and national banks. Although size gave the larger banks some advantages in competing for business from large corporations, including economies of scale and higher lending limits, the organizers believed that these "megabanks" were focused on a mass market approach which de-emphasized personal contact and service. The organizers also believed that the centralization of decision-making power at these large institutions had resulted in a lack of customer service. At many of these institutions, determinations were made at the "home office" by individuals who lacked personal contact with customers as well as an understanding of the customers' needs and scope of the relationship with the institution.

Bay National Bank's management believes that this trend is ongoing, and continues to be particularly frustrating to owners of small and mid-sized businesses, business professionals and high net worth individuals who traditionally have been accustomed to dealing directly with a bank executive who had an understanding of their banking needs with the ability to deliver a prompt response.

Bay National Bank targets its commercial banking services to small and mid-sized businesses and targets its retail banking services to the owners of these businesses and their employees, to business professionals and high net worth individuals.

Bay National Bank seeks to distinguish itself by

- Developing personal relationships with its customers.

- Customizing its products to fit the needs of its customers instead of adopting a "one size fits all" mentality.
- Streamlining the decision making process.
- Offering its customers additional complementary services, such as insurance and investment advice, through relationships with strategic partners.

Bay National Bank's offices are not organized in the traditional retail branch structure, which is transaction and "bank teller" oriented. Instead, Bay National Bank emphasizes a "sit-down" model where customers can choose to be greeted by a personal banker and taken to a private desk. Customers also have the option to conduct their transactions using a more traditional teller counter. Management believes that this approach makes service more individualized and enhances the banker's understanding of the customer's needs. Furthermore, Bay National Bank's branch locations do not focus on capturing every customer within the surrounding area. Instead, they are strategically located in areas convenient to Bay National Bank's target customer base.

Market Area and Facilities

Bay National Bank's headquarters and Baltimore branch office are located at 2328 West Joppa Road, Lutherville, Maryland 21093. Bay National Bank serves the Baltimore metropolitan area from that location, with its primary service area being Towson, Lutherville-Timonium, Cockeysville, Hunt Valley, Ruxton and Roland Park. Bay National Bank's Salisbury, Maryland branch office is located at 109 Poplar Hill Avenue, Salisbury, Maryland 21801, from which it serves Maryland's Eastern Shore.

Products and Services

Loan Portfolio.

Bay National Bank offers a full range of loans, including commercial and industrial loans, real estate loans, consumer loans and residential mortgage and home equity loans. Commercial business and commercial real estate loans for owner-occupied properties are Bay National Bank's primary loan products, accounting for approximately 64% of the loan portfolio as of December 31, 2005.

Generally, Bay National Bank is subject to a lending limit to any one borrower of 15% of Bay National Bank's unimpaired capital and surplus. However, management is able to originate loans and to participate with other lenders in loans that exceed Bay National Bank's lending limits.

The following is a description of the types of loans Bay National Bank has targeted in building its loan portfolio:

- Commercial and industrial loans for business purposes including working capital, equipment purchases, lines of credit and government contract financing. Asset-based lending, accounts receivable financing and lease financing are also available. As of December 31, 2005, these loans represented approximately 38% of Bay National Bank's loan portfolio. In general, Bay National Bank targets small and mid-sized businesses in its market area with credit needs in the range of up to \$5,000,000.
- Commercial real estate loans, including mortgage loans on non-residential properties, and land development and construction loan financing, primarily for owner-occupied premises as well as first and second mortgage loans on commercially owned residential investment properties. As of December 31, 2005, these loans represented approximately 26% of Bay National Bank's loan portfolio.

- Mortgage loans and residential construction loans secured by residential property, including first and second mortgage loans on owner occupied and investment properties (1 to 4 family and multi-family) owned by individuals, and home equity loans secured by single-family owner-occupied residences. As of December 31, 2005, these loans represented approximately 35% of Bay National Bank's loan portfolio. A large portion of these loans, approximately 9% of Bay National Bank's total loan portfolio, are residential real estate loans held for sale. Like its consumer loans, Bay National Bank's residential real estate loans are targeted to business owners and their employees, business professionals and high net worth individuals.
- Consumer loans including automobile and personal loans. In addition, Bay National Bank offers personal lines of credit. As of December 31, 2005, these loans represented approximately 1% of Bay National Bank's loan portfolio. Bay National Bank's consumer loans are targeted to business owners and their employees, business professionals and high net worth individuals.

Bay National Bank originates some of its Eastern Shore residential mortgage loans through BNB Mortgage, LLC, a Maryland limited liability company, which is a joint venture between Bay National Bank and an Ocean City, Maryland real estate agent. Bay National Bank is responsible for all of the operations of BNB Mortgage, LLC. Bay National Bank's share of net income from this entity amounted to \$12,916 and \$24,603 for the years ended December 31, 2005 and 2004, respectively. All loans originated by BNB Mortgage, LLC are immediately sold to Bay National Bank. These loans are then sold to third party investors in the same fashion as other conventional first and second residential mortgage loans originated by Bay National Bank.

Bay National Bank's conventional first and second residential mortgage loans adhere to standards developed by FNMA/FHLMC. Management requires private mortgage insurance for loans in excess of 80% of a property's value. Bay National Bank sells most of its first and second residential mortgage loans in the secondary market. Therefore, management sells those loans that have a lower degree of risk, and a lower yield, relative to the other types of loans that Bay National Bank makes. Since these loans are typically sold, Bay National Bank offers these loans as well as certain residential construction loans to a broader array of individuals than its home equity loans and other consumer loan products. As of December 31, 2005, mortgage loans held for sale totaled \$17,509,064.

Deposits.

Bay National Bank offers a wide range of interest-bearing and non-interest-bearing accounts, including commercial and retail checking accounts, money market accounts, individual retirement accounts, interest-bearing statement savings accounts and certificates of deposit with fixed and variable rates and a range of maturity date options.

Other Banking and Financial Services.

Bay National Bank offers commercial customers cash management services such as sweep accounts, account reconciliation, lockbox services and wire transfers of funds. Additionally, Bay National Bank makes available telephone banking, ATM/debit cards, safe keeping boxes, after-hours deposit services, travelers checks, direct deposit of payroll and automatic drafts for various accounts. These services are provided either directly by Bay National Bank or through correspondent banking relationships. Bay National Bank does not have its own network of ATM machines. In general, Bay National Bank waives fees on a predetermined number of ATM transactions per month, thereby allowing its customers to use any ATM machine.

In addition, Bay National Bank's customers are able to access information about their accounts and view information about Bay National Bank's services and products on Bay National Bank's website, which is located at <http://www.baynational.com>. Bay National Bank's website also permits customers to make transfers of funds among accounts, pay bills and send e-mail to Bay National Bank personnel.

Bay National Bank offers, through strategic partners, investment advisory, risk management and employee benefit services. Through these affiliations, banking clients can receive a full range of financial services, including investment advice, personal and business insurance products and employee benefit products such as pension and 401(k) plan administration. To the extent permitted by applicable regulations, the strategic partners may share fees and commissions with Bay National Bank. As of December 31, 2005, Bay National Bank had not entered in to any such fee arrangements. When sufficient volume is developed in any of these lines of business, Bay National Bank may provide these services if permitted by applicable regulations.

Competition

In both the Baltimore metropolitan area and on Maryland's Eastern Shore, Bay National Bank faces strong competition from large banks headquartered within and outside of Maryland. Bay National Bank also competes with other community banks, savings and loan associations, credit unions, mortgage companies, finance companies and others providing financial services. In addition, insurance companies, securities brokers and other non-bank entities or their affiliates may provide services, which historically have been considered banking in nature.

Many of Bay National Bank's competitors can finance extensive advertising campaigns, maintain extensive branch networks and technology investments, and offer services, which Bay National Bank cannot offer or chooses not to offer. Also, larger institutions have substantially higher lending limits than Bay National Bank. Some of Bay National Bank's competitors have other advantages, such as tax exemption in the case of credit unions, and lesser regulation in the case of mortgage companies and finance companies.

Employees

As of March 22, 2006, Bay National Bank employed fifty-six individuals. Forty-five people operate from Bay National Bank's headquarters, banking office, and mortgage operations in Lutherville, Maryland and eleven people from the Salisbury, Maryland banking office. Bay National Corporation has no employees.

SUPERVISION AND REGULATION

General

Bay National Corporation and Bay National Bank are subject to extensive regulation under state and federal banking laws and regulations. These laws impose specific requirements and restrictions on virtually all aspects of operations and generally are intended to protect depositors, not stockholders. The following discussion is only a summary and readers should refer to particular statutory and regulatory provisions for more detailed information. In addition, management cannot predict the nature or the extent of the effect on business and earnings that new federal or state legislation may have in the future.

Bay National Corporation

Federal Bank Holding Company Regulation. Bay National Corporation is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to supervision by the Federal Reserve Board. As a bank holding company, Bay National Corporation is required to file with the Federal Reserve Board an annual report and such other additional information as the Federal Reserve Board may require by statute. The Federal Reserve Board may also examine Bay National Corporation and each of its subsidiaries.

The Federal Reserve Board must approve, among other things, the acquisition by a bank holding company of control of more than five percent (5%) of the voting shares, or substantially all the assets, of any bank or bank holding company or the merger or consolidation by a bank holding company with another bank holding company. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the restrictions on interstate acquisitions of

banks by bank holding companies were repealed as of September 29, 1995. The effect of the repeal of these restrictions is that, subject to certain time and deposit base requirements, Bay National Corporation may acquire a bank located in Maryland or any other state, and a bank holding company located outside of Maryland can acquire any Maryland-based bank holding company or bank.

Unless it chooses to become a financial holding company, as further described below, a bank holding company is prohibited from acquiring control of any voting shares of any company which is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking, or managing or controlling banks or furnishing services for its authorized subsidiaries. There are limited exceptions. A bank holding company may, for example, engage in activities which the Federal Reserve Board has determined by order or regulation to be so closely related to banking or managing or controlling banks as to be "properly incident thereto." In making such a determination, the Federal Reserve Board is required to consider whether the performance of such activities can reasonably be expected to produce benefits to the public, such as convenience, increased competition or gains in efficiency, which outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The Federal Reserve Board is also empowered to differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern. Some of the activities that the Federal Reserve Board has determined by regulation to be closely related to banking include servicing loans, performing certain data processing services, acting as a fiduciary, investment or financial advisor, and making investments in corporations or projects designed primarily to promote community welfare.

Subsidiary banks of a bank holding company are subject to certain restrictions imposed by statute on any extensions of credit to the bank holding company or any of its subsidiaries, or investments in their stock or other securities, and on taking such stock or securities as collateral for loans to any borrower. Further, a bank holding company and any subsidiary bank are prohibited from engaging in certain tie-in arrangements in connection with the extension of credit. In 1997, the Federal Reserve Board adopted amendments to its Regulation Y, creating exceptions to the Bank Holding Company Act's anti-tying prohibitions that give bank subsidiaries of holding companies greater flexibility in packaging products and services with their affiliates.

In accordance with Federal Reserve Board policy, Bay National Corporation is expected to act as a source of financial strength to Bay National Bank and to commit resources to support Bay National Bank in circumstances in which Bay National Corporation might not otherwise do so. The Federal Reserve Board may require a bank holding company to terminate any activity or relinquish control of a non-bank subsidiary (other than a non-bank subsidiary of a bank) upon the Federal Reserve's determination that such activity or control constitutes a serious risk to the financial soundness or stability of any subsidiary depository institution of the bank holding company. Further, federal bank regulatory authorities have additional discretion to require a bank holding company to divest itself of any bank or non-bank subsidiary if the agency determines that divestiture may aid the depository institution's financial condition.

On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act ("GLBA"). Effective March 11, 2000, pursuant to authority granted under the GLBA, a bank holding company may elect to become a financial holding company and thereby engage in a broader range of financial and other activities than are permissible for traditional bank holding companies. In order to qualify for the election, all of the depository institution subsidiaries of the bank holding company must be well capitalized and well managed, as defined by regulation, and all of its depository institution subsidiaries must have achieved a rating of satisfactory or better with respect to meeting community credit needs.

Pursuant to the GLBA, financial holding companies will be permitted to engage in activities that are "financial in nature" or incidental or complementary thereto, as determined by the Federal Reserve Board. The GLBA identifies several activities as "financial in nature," including, among others, insurance underwriting and agency, investment advisory services, merchant banking and underwriting, and dealing or making a market in securities. Being designated a financial holding company will allow insurance companies, securities brokers and other types of financial companies to affiliate with and/or acquire depository institutions.

As a bank holding company with consolidated assets of more than \$150,000,000, Bay National Corporation also is subject to certain risk-based capital guidelines imposed on bank holding companies by the Federal Reserve Board to insure the holding company's capital adequacy.

The status of Bay National Corporation as a registered bank holding company under the Bank Holding Company Act does not exempt it from certain federal and state laws and regulations applicable to corporations generally, including, without limitation, certain provisions of the federal securities laws.

State Bank Holding Company Regulation. Bay National Corporation is a Maryland-chartered bank holding company and is subject to various restrictions on its activities as set forth in Maryland law, in addition to those restrictions set forth in federal law.

Under Maryland law, a bank holding company that desires to acquire a Maryland state-chartered bank or trust company, a federally chartered bank with its main office in Maryland, or a bank holding company that has its principal place of business in Maryland, must file an application with the Maryland Commissioner of Financial Regulation (the "Commissioner"). In approving the application, the Commissioner must consider whether the acquisition may be detrimental to the safety and soundness of the entity being acquired or whether the acquisition may result in an undue concentration of resources or a substantial reduction in competition in Maryland. The Commissioner may not approve an acquisition if, on consummation of the transaction, the acquiring company, together with all its insured depository institution affiliates, would control 30% or more of the total amount of deposits of insured depository institutions in Maryland. The Commissioner has authority to adopt by regulation a procedure to waive this requirement for good cause. In a transaction for which the Commissioner's approval is not required due to an exemption under Maryland law, or for which federal law authorizes the transaction without application to the Commissioner, the parties to the acquisition must provide written notice to the Commissioner at least 15 days before the effective date of the acquisition.

Bay National Bank

General. Bay National Bank, as a national banking association whose accounts are insured by the Bank Insurance Fund ("BIF") of the Federal Deposit Insurance Corporation ("FDIC") up to the maximum legal limits, is subject to regulation, supervision and regular examinations by the Office of the Comptroller of the Currency ("OCC"). Bay National Bank is a member of the Federal Reserve System and, as such, is subject to certain regulations issued by the Federal Reserve Board. Bay National Bank also is subject to applicable banking provisions of Maryland law insofar as they do not conflict with or are not preempted by federal law. The regulations of these various agencies govern most aspects of Bay National Bank's business, including setting required reserves against deposits, loans, investments, mergers and acquisitions, borrowing, dividends, and location and number of branch offices.

The GLBA authorizes expanded activities for national banks, but requires (with the exception of underwriting municipal revenue bonds and other state and local obligations) that any expanded activities be conducted in a new entity called a "financial subsidiary" that is a subsidiary of the bank rather than the bank itself. A financial subsidiary may engage in any activities in which a financial holding company or a financial holding company's non-bank subsidiaries can engage, except that a financial subsidiary may not underwrite most insurance, engage in real estate development or conduct merchant banking activities. A financial subsidiary may be established through acquisition or *de novo*.

In order for a national bank to operate a financial subsidiary, it must be well capitalized and well managed, have a satisfactory or better rating with respect to meeting community credit needs and the aggregate assets of all of the bank's financial subsidiaries may not exceed 45% of the total assets of the bank, subject to certain exceptions. Existing authority of the OCC and the FDIC to review subsidiary activities are preserved.

Banking is a business which depends on interest rate differentials. In general, the differences between the interest paid by a bank on its deposits and its other borrowings and the interest received by a bank on loans extended to its customers and securities held in its investment portfolio constitute the major portion of a bank's earnings. Thus, the earnings and growth of Bay National Bank will be subject to the influence of economic conditions generally, both domestic and foreign, and also on the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve Board, which regulates the supply of money.

Branching and Interstate Banking. Beginning on June 1, 1997, the federal banking agencies were authorized to approve interstate bank merger transactions without regard to whether such a transaction is prohibited by the law of any state, unless the home state of one of the banks has opted out of the interstate bank merger provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Furthermore, under the Riegle-Neal Act, interstate acquisitions of branches are permitted if the law of the state in which the branch is located permits such acquisitions. The Riegle-Neal Act also authorizes the OCC and FDIC to approve interstate branching de novo by national and non-member banks, respectively, but only in states which specifically allow for such branching.

The District of Columbia, Maryland, Delaware and Pennsylvania have all enacted laws which permit interstate acquisitions of banks and bank branches and permit out-of-state banks to establish de novo branches.

Capital Adequacy Guidelines. The Federal Reserve Board, the OCC and the FDIC have all adopted risk-based capital adequacy guidelines by which they assess the adequacy of capital in examining and supervising banks and bank holding companies and in analyzing bank regulatory applications. Risk-based capital requirements determine the adequacy of capital based on the risk inherent in various classes of assets and off-balance sheet items.

Since December 31, 1992, national banks have been expected to meet a minimum ratio of total qualifying capital (the sum of core capital (Tier 1) and supplementary capital (Tier 2)) to risk-weighted assets (a "Total Risk-Based Capital Ratio") of 8%. At least half of this amount (4%) should be in the form of core capital. These requirements apply to Bay National Bank.

Tier 1 capital for national banks generally consists of the sum of common stockholders' equity and perpetual preferred stock (subject in the case of the latter to limitations on the kind and amount of such stock which may be included as Tier 1 capital), less goodwill, without adjustment in accordance with Statement of Financial Accounting Standards No. 115. Tier 2 capital consists of the following: hybrid capital instruments, perpetual preferred stock which is not otherwise eligible to be included as Tier 1 capital, term subordinated debt and intermediate-term preferred stock, and, subject to limitations, general allowances for loan losses. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no risk-based capital) for assets such as cash, to 100% for the bulk of assets which are typically held by a bank holding company, including certain multi-family residential and commercial real estate loans, commercial business loans and consumer loans. Residential first mortgage loans on one-to-four-family residential real estate and certain seasoned multi-family residential real estate loans, which are not 90 days or more past-due or non-performing and which have been made in accordance with prudent underwriting standards, are assigned a 50% level in the risk-weighting system, as are certain privately issued mortgage-backed securities representing indirect ownership of such loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics.

In addition to the risk-based capital requirements, the OCC has established a minimum 3% Leverage Capital Ratio (Tier 1 capital to total adjusted assets) requirement for the most highly-rated national banks, with an additional cushion of at least 100 to 200 basis points for all other national banks, which effectively increases the minimum Leverage Capital Ratio for such other banks to 4%-5% or more. Under the OCC's regulations, highest-rated banks are those that the OCC determines are not anticipating or experiencing significant growth and have well diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, those which are considered a strong banking organization. A national bank that has less than the minimum Leverage Capital Ratio requirement must submit, to the applicable district office for review and approval, a reasonable plan

describing the means and timing by which the bank will achieve its minimum Leverage Capital Ratio requirement. A national bank which fails to file such a plan is deemed to be operating in an unsafe and unsound manner and could be subject to a cease-and-desist order.

The OCC's regulations also provide that any insured depository institution with a Leverage Capital Ratio less than 2% is deemed to be operating in an unsafe or unsound condition. Operating in an unsafe or unsound manner could lead the FDIC to terminate deposit insurance. However, such an institution will not be subject to an enforcement proceeding solely on account of its capital ratios if it has entered into and is in compliance with a written agreement with the OCC to increase its Leverage Capital Ratio to such level as the OCC deems appropriate and to take such other action as may be necessary for the institution to be operated in a safe and sound manner. The capital regulations also provide, among other things, for the issuance by the OCC or its designee(s) of a capital directive, which is a final order issued to a bank that fails to maintain minimum capital or to restore its capital to the minimum capital requirement within a specified time period. Such directive is enforceable in the same manner as a final cease-and-desist order.

Prompt Corrective Action. Each federal banking agency is required to implement a system of prompt corrective action for institutions which it regulates. Under applicable regulations, a bank will be deemed to be: (i) "well capitalized" if it has a Total Risk-Based Capital Ratio of 10% or more, a Tier 1 Risk-Based Capital Ratio of 6% or more, a Leverage Capital Ratio of 5% or more and is not subject to any written capital order or directive; (ii) "adequately capitalized" if it has a Total Risk-Based Capital Ratio of 8% or more, a Tier 1 Risk-Based Capital Ratio of 4% or more and a Leverage Capital Ratio of 4% or more (3% under certain circumstances); (iii) "undercapitalized" if it has a Total Risk-Based Capital Ratio that is less than 8%, a Tier 1 Risk-Based Capital Ratio that is less than 4% or a Leverage Capital Ratio that is less than 4% (3.3% under certain circumstances); (iv) "significantly undercapitalized" if it has a Total Risk-Based Capital Ratio that is less than 6%, a Tier 1 Risk-Based Capital Ratio that is less than 3% or a Leverage Capital Ratio that is less than 3%; and (v) "critically undercapitalized" if it has a ratio of tangible equity to total assets that is equal to or less than 2%. Bay National Bank is "well capitalized" as of December 31, 2005.

An institution generally must file a written capital restoration plan which meets specified requirements with an appropriate federal banking agency within 45 days of the date the institution receives notice or is deemed to have notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. The federal banking agency must provide the institution with written notice of approval or disapproval within 60 days after receiving the capital restoration plan, subject to extensions by the applicable agency.

An institution which is required to submit a capital restoration plan must concurrently submit a performance guaranty by each company that controls the institution. Such guaranty is limited to the lesser of (i) an amount equal to 5% of the institution's total assets at the time the institution was notified or deemed to have notice that it was undercapitalized or (ii) the amount necessary at such time to restore the relevant capital measures of the institution to the levels required for the institution to be classified as adequately capitalized. Such a guaranty expires after the federal banking agency notifies the institution that it has remained adequately capitalized for each of four consecutive calendar quarters. An institution which fails to submit a written capital restoration plan within the requisite period, including any required performance guaranty, or fails in any material respect to implement a capital restoration plan, is subject to the restrictions in Section 38 of the Federal Deposit Insurance Act which are applicable to significantly undercapitalized institutions.

A critically undercapitalized institution will be placed in conservatorship or receivership within 90 days unless the FDIC formally determines that forbearance from such action would better protect the deposit insurance fund. Unless the FDIC or another appropriate federal banking regulatory agency makes specific further findings and certifies that the institution is viable and is not expected to fail, an institution that remains critically undercapitalized on average during the four calendar quarters after the date it becomes critically undercapitalized must be placed in receivership.

Immediately upon becoming undercapitalized, an institution becomes subject to statutory provisions which (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution's assets; and (v) require prior approval of certain expansion proposals. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the deposit insurance fund, subject, in certain cases, to specified procedures. These discretionary supervisory actions include requiring the institution to raise additional capital, restricting transactions with affiliates, requiring divestiture of the institution or the sale of the institution to a willing purchaser, and any other supervisory action that the agency deems appropriate. Significantly undercapitalized and critically undercapitalized institutions are subject to these and additional mandatory and permissive supervisory actions.

Regulatory Enforcement Authority. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") included substantial enhancement to the enforcement powers available to federal banking regulators. This enforcement authority included, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties, as defined in FIRREA. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities. FIRREA significantly increased the amount of and grounds for civil money penalties and requires, except under certain circumstances, public disclosure of final enforcement actions by the federal banking agencies.

Deposit insurance. The FDIC has adopted a risk-based deposit insurance assessment system. The FDIC assigns an institution to one of three capital categories based on the institution's financial information, as of the reporting period ending seven months before the assessment period, consisting of (i) well capitalized, (ii) adequately capitalized or (iii) undercapitalized, and one of three supervisory subcategories within each capital group. The supervisory subgroup to which an institution is assigned is based on a supervisory evaluation provided to the FDIC by the institution's primary federal regulator and information that the FDIC determines to be relevant to the institution's financial condition and the risk posed to the deposit insurance funds. An institution's assessment rate depends on the capital category and supervisory subcategory to which it is assigned. Assessment rates for BIF deposits currently range from 0 basis points to 27 basis points. Bay National Bank is currently assigned to a capital and supervisory subcategory that has an assessment rate of 0. The FDIC is authorized to raise the assessment rates in certain circumstances, including to maintain or achieve the designated reserve ratio of 1.25%, which requirement the BIF currently meets. The FDIC has exercised its authority to raise rates in the past and may raise insurance premiums in the future. If such action is taken by the FDIC, it could have an adverse effect on the earnings of Bay National Bank.

Under the Federal Deposit Insurance Act, insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

Transactions with Affiliates and Insiders. Bay National Bank is subject to the provisions of Section 23A of the Federal Reserve Act, which place limits on the amount of loans or extensions of credit to affiliates, investments in or certain other transactions with affiliates and on the amount of advances to third parties collateralized by the securities or obligations of affiliates. Section 23A limits the aggregate amount of transactions with any individual affiliate to ten percent (10%) of the capital and surplus of Bay National Bank and also limits the aggregate amount of transactions with all affiliates to twenty percent (20%) of capital and surplus. Loans and certain other extensions of credit to affiliates are required to be secured by collateral in an amount and of a type described in Section 23A, and the purchase of low quality assets from affiliates is generally prohibited.

Bay National Bank also is subject to the provisions of Section 23B of the Federal Reserve Act which, among other things, prohibit an institution from engaging in certain transactions with certain affiliates unless the transactions are on terms substantially the same, or at least as favorable to such institution and/or its subsidiaries, as those prevailing at the time for comparable transactions with non-affiliated entities. In the absence of comparable transactions, such transactions may only occur under terms and circumstances, including credit standards that in good faith would be offered to or would apply to non-affiliated companies.

Bay National Bank also is subject to the restrictions contained in Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O thereunder on loans to executive officers, directors and principal stockholders. Under Section 22(h), loans to a director, an executive officer or a greater-than-10% stockholder of a bank as well as certain affiliated interests of any of the foregoing may not exceed, together with all other outstanding loans to such person and affiliated interests, the loans-to-one-borrower limit applicable to national banks (generally 15% of the institution's unimpaired capital and surplus), and all loans to all such persons in the aggregate may not exceed the institution's unimpaired capital and unimpaired surplus. Regulation O also prohibits the making of loans in an amount greater than \$25,000 or 5% of capital and surplus but in any event not over \$500,000, to directors, executive officers and greater-than-10% stockholders of a bank, and their respective affiliates, unless such loans are approved in advance by a majority of the Board of Directors of the bank with any "interested" director not participating in the voting. Further, Regulation O requires that loans to directors, executive officers and principal stockholders be made on terms substantially the same as those that are offered in comparable transactions to other persons. Regulation O also prohibits a depository institution from paying overdrafts over \$1,000 of any of its executive officers or directors unless they are paid pursuant to written pre-authorized extension of credit or transfer of funds plans.

Loans to One Borrower. As a national bank, Bay National Bank is subject to the statutory and regulatory limits on the extension of credit to one borrower. Generally, the maximum amount of total outstanding loans that a national bank may have to any one borrower at any one time is 15% of the bank's unimpaired capital and surplus. A national bank may lend an additional 10% on top of the 15% if the amount that exceeds 15% of the bank's unimpaired capital and surplus is fully secured by readily marketable collateral.

Liquidity. Bay National Bank is subject to the reserve requirements of Federal Reserve Board Regulation D, which applies to all depository institutions. Specifically, as of December 22, 2005, amounts in transaction accounts above \$7,800,000 and up to \$48,300,000 must have reserves held against them in the ratio of three percent of the amount. Amounts above \$48,300,000 require reserves of \$1,215,000 plus 10 percent of the amount in excess of \$48,300,000. Bay National Bank is in compliance with the applicable liquidity requirements.

Community Reinvestment Act. The Community Reinvestment Act ("CRA") requires that, in connection with examinations of financial institutions within their respective jurisdictions, the Federal Reserve Board, the FDIC, the OCC or the Office of Thrift Supervision shall evaluate the record of the financial institutions in meeting the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. An institution's CRA activities are considered in, among other things, evaluating mergers, acquisitions and applications to open a branch or facility as well as determining whether the institution will be permitted to exercise certain of the powers allowed by the GLBA. The CRA also requires all institutions to make public disclosure of their CRA ratings. Bay National Bank received a "satisfactory" rating in its latest CRA examination in May 2003.

USA PATRIOT Act. On October 26, 2001, the President signed into law comprehensive anti-terrorism legislation known as the USA PATRIOT Act of 2001 (the “USA Patriot Act”). Title III of the USA Patriot Act substantially broadened the scope of U.S. anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. The U.S. Treasury Department (“Treasury”) has issued a number of implementing regulations that apply to various requirements of the USA Patriot Act to financial institutions such as Bay National Bank. Those regulations impose new obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing. Treasury may issue additional regulations that will further clarify the USA Patriot Act’s requirements.

Failure of a financial institution to comply with the USA Patriot Act’s requirements could have serious legal and reputational consequences for the institution. The Company has adopted appropriate policies, procedures and controls to address compliance with the requirements of the USA Patriot Act under the existing regulations and will continue to revise and update its policies, procedures and controls to reflect changes required by the USA Patriot Act and Treasury’s regulations.

FORWARD LOOKING STATEMENTS

Some of the matters discussed in this annual report including under the captions “Business of Bay National Corporation and Bay National Bank,” and “Management’s Discussion And Analysis Of Financial Condition And Results Of Operations” include forward-looking statements. These forward-looking statements include statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk and financial and other goals. Forward-looking statements often use words such as “believe,” “expect,” “plan,” “may,” “will,” “should,” “project,” “contemplate,” “anticipate,” “forecast,” “intend”, or other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts. When you read a forward-looking statement, you should keep in mind the risk factors described below and any other information contained in this annual report which identifies a risk or uncertainty. Bay National Corporation’s actual results and the actual outcome of Bay National Corporation’s expectations and strategies could be different from that described in this annual report because of these risks and uncertainties and you should not put undue reliance on any forward-looking statements. All forward-looking statements speak only as of the date of this filing, and Bay National Corporation undertakes no obligation to make any revisions to the forward-looking statements to reflect events or circumstances after the date of this filing or to reflect the occurrence of unanticipated events.

RISK FACTORS

You should carefully consider the following risks, along with the other information contained in this annual report. The risks and uncertainties described below are not the only ones that may affect Bay National Corporation. Additional risks and uncertainties may also adversely affect our business and operations including those discussed in Item 6 - Management’s Discussion and Analysis of Financial Condition and Results of Operations. If any of the following events actually occur, our business and financial results could be materially adversely affected.

Bay National Corporation and Bay National Bank depend heavily on one key employee, Mr. Hugh W. Mohler, and business would suffer if something were to happen to Mr. Mohler. Mr. Mohler is the Chairman, President and Chief Executive Officer of Bay National Bank. If he were to leave for any reason, Bay National Corporation’s and Bay National Bank’s business would suffer because he has banking experience and relationships with clients and potential clients that would not be easy to replace. In addition, because Bay National Bank’s business is relationship driven, the loss of an employee who has primary contact with one or more of Bay National Bank’s clients could cause Bay National Bank to lose those clients’ business, possibly resulting in a decline in revenues.

If our allowance for credit losses is not sufficient to cover actual loan losses, our earnings could decrease. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of collateral for the repayment of many of our loans. In determining the amount of the allowance for credit losses, we review, among other things, our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for credit losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance.

We are particularly susceptible to this risk because we are a relatively new bank and have experienced significant growth over the past few years. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process referred to as “seasoning.” As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because a large portion of our loan portfolio is relatively new, the current level of delinquencies and defaults may not be representative of the level that will prevail when the portfolio becomes more seasoned, which may be higher than current levels. If delinquencies and defaults increase, we may be required to increase our provision for loan losses.

Material additions to our allowance would materially decrease our net income. In addition, bank regulators periodically review our allowance for credit losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for credit losses or loan charge-offs may have a material adverse effect on our results of operations and financial condition.

Bay National Bank’s lending strategy involves risks resulting from the choice of loan portfolio. Bay National Bank's loan strategy emphasizes commercial business loans and commercial real estate loans. At December 31, 2005, such loans accounted for approximately 64% of the loan portfolio. Commercial business and commercial real estate loans generally carry a higher degree of credit risk than do residential mortgage loans because of several factors including larger loan balances, dependence on the successful operation of a business or a project for repayment, or loan terms with a balloon payment rather than full amortization over the loan term.

Bay National Bank’s lending limit may limit its growth and the growth of Bay National Corporation. Bay National Bank is limited in the amount it can loan to a single borrower by the amount of its capital. Specifically, under current law, Bay National Bank may lend up to 15% of its unimpaired capital and surplus to any one borrower. Bay National Bank’s lending limit is significantly less than that of many of its competitors and may discourage potential borrowers who have credit needs in excess of Bay National Bank’s lending limit from conducting business with Bay National Bank.

Bay National Bank faces substantial competition which could adversely affect its ability to attract depositors and borrowers. Bay National Bank operates in a competitive market for financial services and faces intense competition from other institutions both in making loans and in attracting deposits. Many of these institutions have been in business for many years, are significantly larger, have established customer bases, have greater financial resources and lending limits than Bay National Bank, and are able to offer certain services that Bay National Bank is not able to offer. If Bay National Bank cannot attract deposits and make loans at a sufficient level, its operating results will suffer, as will its opportunities for growth.

Government regulation could restrict Bay National Corporation’s or Bay National Bank’s growth or cause Bay National Corporation or Bay National Bank to incur higher costs. Bay National Corporation and Bay National Bank operate in a highly regulated environment and are subject to examination, supervision and comprehensive regulation by several federal and state regulatory agencies. Banking regulations, designed primarily for the safety of depositors, may limit the growth of Bay National Bank and the return to investors by restricting activities such as the payment of dividends; mergers with, or acquisitions by, other institutions; investments; loans and interest rates; interest rates paid on deposits; and the creation of branch offices. Laws and regulations could change at any time, and changes could adversely affect Bay National Corporation’s and Bay National Bank’s business. In addition, the cost of compliance with regulatory requirements could adversely affect Bay National Corporation’s and Bay National Bank’s ability to operate

profitably.

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Bay National Bank's ability to compete may suffer if it cannot take advantage of technology to provide banking services or if its customers fail to embrace that technology. Bay National Bank's business strategy relies less on customers' access to a large branch network and more on access to technology and personal relationships. Further, the market for financial services is increasingly affected by advances in technology, including developments in telecommunications, data processing, computers, automation, Internet-based banking and, tele-banking. Bay National Bank's ability to compete successfully may depend on the extent to which Bay National Bank can take advantage of technological changes and the extent to which Bay National Bank's customers embrace technology to complete their banking transactions.

Because we currently serve limited market areas, we could be more adversely affected by an economic downturn in our market areas than our larger competitors which are more geographically diverse. Currently, our primary market area is limited to the Baltimore metropolitan area and Maryland's Eastern Shore. If either of these areas suffer an economic downturn, our business and financial condition may be severely affected. Our larger competitors serve a more geographically diverse market area, parts of which may not be affected by the same economic conditions that exist in our primary market areas.

If economic conditions deteriorate, our results of operations and financial condition could be adversely affected as borrowers' ability to repay loans declines and the value of the collateral securing our loans decreases. Our financial results may be adversely affected by changes in prevailing economic conditions, including decreases in real estate values, changes in interest rates which may cause a decrease in interest rate spreads, adverse employment conditions, the monetary and fiscal policies of the federal government and other significant external events. Because a significant portion of our loan portfolio is comprised of real estate related loans, decreases in real estate values could adversely affect the value of property used as collateral. Adverse changes in the economy also may have a negative effect on the ability of our borrowers to make timely repayments of their loans, which would have an adverse impact on our earnings.

Our profitability depends on interest rates and changes in monetary policy may impact us. Our results of operations depend to a large extent on our "net interest income," which is the difference between the interest expense incurred in connection with our interest-bearing liabilities, such as interest on deposit accounts, and the interest income received from our interest-earning assets, such as loans. Interest rates, because they are influenced by, among other things, expectations about future events, including the level of economic activity, federal monetary and fiscal policy and geo-political stability, are not predictable or controllable. In addition, competitive factors heavily influence the interest rates we can earn on our loan and investment portfolios and the interest rates we pay on our deposits. Community banks are often at a competitive disadvantage in managing their cost of funds compared to the large regional, super-regional or national banks that have access to the national and international capital markets. These factors influence our ability to maintain a stable interest margin.

The costs of being a public company are proportionately higher for small companies like us due to the requirement of the Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 and the related rules and regulations promulgated by the Securities and Exchange Commission have increased the scope, complexity, and cost of corporate governance, reporting, and disclosure practices. These regulations are applicable to our company. We expect to experience increasing compliance costs, including costs related to internal controls, as a result of the Sarbanes-Oxley Act. These necessary costs are proportionately higher for a company of our size and will affect our profitability more than that of some of our larger competitors.

Item 2. Description of Property

Baltimore

Our Baltimore offices are located at 2328 West Joppa Road, Lutherville, Maryland 21093. Currently, we lease space in the basement (1,429 square feet), the first floor (4,067 square feet) and the third floor (6,206 square feet) of this building. The basement space and 947 square feet of the first floor space are currently used for the Lutherville residential mortgage operation, 2,355 square feet of the first floor space is used for the Lutherville branch office, 765 square feet of the first floor is sublet and the third floor space is used for Bay National Corporation and Bay National Bank's administrative offices. The current lease expires on February 28, 2010, and we have the right to extend the lease for one five-year term to February 28, 2015.

As of December 31, 2005, Bay National Corporation was paying rent of \$339,096 per year, or \$28,258 per month for all of the leased space in the building. For the March 2006 to February 2007 lease year, Bay National Corporation will pay annual rent of \$349,268, or \$29,106 per month. For each lease year thereafter, including any lease years during any renewal term, the yearly base rent will increase by three percent. The rent includes Bay National Corporation's share of taxes and building operating costs.

Beginning November 15, 2004, Bay National Corporation sublet approximately 765 square feet of the space on the first floor for a term through December 31, 2006 at a monthly rent for the first year of \$1,893, which amount increases at the rate of three percent per year. Upon the termination of the sublease on December 31, 2006, management expects that it will convert this space for use by Bay National Corporation and Bay National Bank in order to accommodate current and future growth.

The Landlord, Joppa Green II Limited Partnership, LLLP, is beneficially owned by the MacKenzie Companies. Gary T. Gill, who has been a director of Bay National Corporation and Bay National Bank since January 2003, is the president and chief executive officer of the MacKenzie Companies. See "Item 12 - Certain Relationships and Related Transactions."

Salisbury

On September 16, 1999, Bay National Corporation entered into a lease agreement for Bay National Bank's Salisbury, Maryland branch office, which is located at 109 Poplar Hill Avenue, Salisbury Maryland 21801 in a two-story building containing approximately 2,500 square feet of office space. This lease, which became effective as of September 1, 1999, was for a term of five years with Bay National Corporation having the option to extend the term for three five-year renewal terms.

Bay National Corporation exercised its option to extend this lease which will now terminate on August 31, 2009, unless extended. During the new lease term, Bay National Corporation is paying monthly rent of approximately \$2,292, plus all real estate taxes and utilities. Pursuant to this lease, Bay National Corporation has a right of first refusal to purchase the building in the event the landlord receives a bona fide offer to sell. This property is owned by John R. Lerch, who has been a director of Bay National Corporation and Bay National Bank since their formation. See "Item 12 - Certain Relationships and Related Transactions."

On September 1, 2002, Bay National Corporation entered into a lease agreement for Bay National Bank's Salisbury, Maryland mortgage division office, which is located at 318 East Main Street, Salisbury Maryland 21801. The leased space consists of two office suites totaling approximately 420 square feet. This lease, which became effective as of January 1, 2003, was for a term of one year with Bay National Corporation having the option to extend the term for one additional one-year renewal term. Bay National Corporation renewed the lease for an additional one year term

effective as of January 1, 2004. During the initial lease term and the renewal term, Bay National Corporation paid monthly rent of \$700. The lease expired on December 31, 2004 and reverted to a monthly rental arrangement. On January 1, 2005, Bay National Corporation obtained an additional 200 square feet in the same building. The total space of 620 square feet was rented on a month to month basis at a cost of \$1,000 per month through November 2005 at which time the additional 200 square feet was returned to the landlord. The remaining 420 square feet is currently rented on a month to month basis at a cost of \$700 per month. The landlord is responsible for all real estate taxes and utilities.

Item 3. Legal Proceedings

There are no pending legal proceedings to which Bay National Corporation or Bay National Bank is a party or to which any of their properties are subject, nor are there proceedings known to Bay National Corporation to be contemplated by any governmental authority. There are no material proceedings known to Bay National Corporation, pending or contemplated, in which any director, officer or affiliate or any principal security holder of Bay National Corporation is a party adverse to Bay National Corporation or Bay National Bank or has a material interest adverse to Bay National Corporation or Bay National Bank.

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

No matter was submitted during the fourth quarter of the year ended December 31, 2005 to a vote of security holders of Bay National Corporation.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters

As of March 22, 2006, the number of holders of record of Bay National Corporation's common stock was approximately 399. Bay National Corporation's common stock is traded on the Over the Counter Bulletin Board ("OTCBB") under the symbol "BANI.OB."

Bay National Corporation completed an initial public offering ("IPO") of its common stock on April 30, 2000. Stock prices subsequent to the IPO are based upon limited trading on the OTCBB. The following table reflects the high and low sales information as reported on the OTCBB for the periods presented. Quotations reflect inter-dealer prices, without retail mark-up, mark-down, or commission and may not represent actual transactions.

Quarter	2005		2004	
	Bid Price Range		Bid Price Range	
	Low	High	Low	High
1 st	\$ 13.20	\$ 15.25	\$ 10.10	\$ 14.00
2 nd	14.50	19.75	11.75	14.00
3 rd	17.25	21.00	10.00	12.50
4 th	18.80	23.00	10.50	13.25

To date, Bay National Corporation has not declared or paid any dividends on its common stock. Management anticipates that Bay National Corporation will retain all earnings, if any, in order to provide more funds to operate and expand Bay National Corporation's business and, therefore, Bay National Corporation has no plans to pay any cash dividends at least until its profitability exceeds the level necessary to support capital growth in excess of regulatory capital needs. If Bay National Corporation decides to pay dividends in the future, its ability to do so will depend on the ability of Bay National Bank to pay dividends to Bay National Corporation. In addition, management would consider a number of other factors before deciding to pay dividends, including Bay National Corporation's earnings prospects, financial condition and cash needs.

The amount of dividends that may be paid by Bay National Bank to Bay National Corporation depends on Bay National Bank's earnings and capital position and is limited by statute, regulations and regulatory policies. As a national bank, Bay National Bank may not pay dividends from its permanent capital. All cash dividends must be paid out of undivided profits then on hand, after deducting expenses, including provisions for loan losses and bad debts. In addition, a national bank is prohibited from declaring a cash dividend on its shares of common stock until its surplus equals its stated capital, unless there has been transferred to surplus no less than one-tenth of the bank's net profits for the preceding two consecutive half-year periods (in the case of an annual dividend). The approval of the OCC is required if the total of all cash dividends declared by a national bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits for the preceding two years, less any required transfers to surplus. In addition, Bay National Bank may not pay a dividend if, after paying the dividend, it would be "undercapitalized" as defined in the applicable regulations.

Recent Sales of Unregistered Securities

From July 13, 2004 to November 12, 2004, Bay National Corporation issued 55,000 shares of its common stock, \$0.01 par value per share, at a purchase price of \$10.00 per share, and received aggregate proceeds of \$550,000. The shares were issued upon the exercise of outstanding warrants.

On September 10, 1999, Bay National Corporation issued warrants to purchase 56,250 shares of its common stock, \$0.01 par value per share, to investors in its organizational offering. The warrants became exercisable on April 30, 2001 and expired on November 16, 2004. 1,250 of the warrants were not exercised prior to their expiration.

There were no underwriting discounts or commissions paid with respect to the issuance of the common stock upon exercise of the warrants. Bay National Corporation believes that the issuance of the shares of common stock upon exercise of the warrants was exempt from the registration requirements of the Securities Act of 1933 by virtue of Section 4(2) of the Securities Act of 1933 and Rule 506 promulgated thereunder. The transaction was not conducted by any form of general solicitation or general advertising and, in connection with the transaction, Bay National Corporation is taking reasonable care to assure that the purchasers of the common stock upon exercise of the warrants are not underwriters within the meaning of Section 2(11) of the Securities Act by, among other things, placing appropriate restrictive legends on the share certificates.

SELECTED FINANCIAL DATA
AS OF DECEMBER 31, 2005, 2004, 2003, 2002 and 2001
(dollars in thousands, except per share data)

	2005	2004	2003	2002	2001
Total assets	\$ 209,966	\$ 170,763	\$ 122,328	\$ 84,609	\$ 47,026
Cash and due from banks	1,461	1,403	573	363	3,065
Federal funds sold and other overnight investments	6,033	16,709	17,487	11,753	6,488
Investment securities available for sale	1,540	1,544	1,548	948	-
Federal Reserve Bank stock	452	313	313	276	276
Federal Home Loan Bank stock	342	243	168	80	-
Loans, net	196,590	149,217	101,049	70,045	36,097
Deposits	182,573	153,927	108,531	76,079	38,139
Short-term borrowings	1,444	1,381	1,222	507	-
Note payable	-	1,250	-	-	-
Subordinated debt	8,000	-	-	-	-
Stockholders' equity	16,214	13,419	12,067	7,610	8,602
Common shares outstanding	1,924,436	1,917,710	1,862,710	1,242,020	1,242,020
Book value per share	\$ 8.43	\$ 7.00	\$ 6.48	\$ 6.13	\$ 6.93
Ratio of interest earning assets to interest bearing liabilities	126.38%	124.95%	127.61%	127.68%	134.86%
Stockholders' equity as a percentage of assets	7.72%	7.86%	9.86%	8.99%	18.29%

SELECTED FINANCIAL RATIOS
FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, 2003, 2002 and 2001

Weighted average yield/rate on:	2005	2004	2003	2002	2001
Loans and loans held for sale	7.46%	5.89%	5.98%	6.52%	7.38%
Investments and interest bearing cash balances	2.27%	1.11%	.80%	1.36%	3.79%
Deposits and short-term borrowings	2.96%	2.17%	2.26%	2.84%	3.70%
Net interest spread	4.12%	3.14%	2.81%	2.80%	2.31%
Net interest margin	4.74%	3.60%	3.29%	3.43%	3.58%

SELECTED OPERATIONAL DATA
FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, 2003, 2002 and 2001
(dollars in thousands, except per share data)

	2005	2004	2003	2002	2001
Interest income	\$ 12,983	\$ 7,624	\$ 5,520	\$ 3,486	\$ 1,882
Interest expense	4,294	2,464	1,937	1,367	760
Net interest income	8,689	5,160	3,583	2,119	1,122
Provision for credit losses	1,179	560	415	405	377
Net interest income after provision for credit losses	7,510	4,600	3,168	1,714	745
Non-interest income	750	539	626	479	187

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Non-interest expenses	6,171	4,337	3,786	3,185	2,548
Income (loss) before income taxes	2,089	802	8	(992)	(1,616)
Income tax benefit	655	-	-	-	-
Net income (loss)	\$ 2,744	\$ 802	\$ 8	\$ (992)	\$ (1,616)

PER COMMON SHARE

Basic net income (loss) per share	\$ 1.43	\$.43	\$.00	\$ (.80)	\$ (1.30)
Diluted net income (loss) per share	\$ 1.37	\$.41	\$.00	\$ (.80)	\$ (1.30)
Average shares outstanding (Basic)	1,922,580	1,877,929	1,660,348	1,242,020	1,242,020
Average shares outstanding (Diluted)	2,002,225	1,936,693	1,682,905	1,242,020	1,242,020

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of Bay National Corporation's financial condition and results of operations should be read in conjunction with Bay National Corporation's consolidated financial statements, the notes thereto and the other information included in this annual report.

This discussion and analysis provides an overview of the financial condition and results of operations of Bay National Corporation ("Parent") and its national bank subsidiary, Bay National Bank ("Bank"), (collectively the "Company"), as of December 31, 2005 and 2004 and for the years ended December 31, 2005, 2004, and 2003.

General

The Parent was incorporated on June 3, 1999 under the laws of the State of Maryland to operate as a bank holding company of the Bank. The Bank commenced operations on May 12, 2000.

The principal business of the Company is to make loans and other investments and to accept time and demand deposits. The Company's primary market areas are in the areas North of Baltimore and the areas surrounding Salisbury, Maryland, although the Company's business development efforts generate business outside of these areas. The Company offers a broad range of banking products, including a full line of business and personal savings and checking accounts, money market demand accounts, certificates of deposit, and other banking services. The Company funds a variety of loan types including commercial and residential real estate loans, commercial term loans and lines of credit, consumer loans, and letters of credit with an emphasis on meeting the borrowing needs of small businesses. The Company's target customers are small closely held businesses, business owners, professionals and high net worth individuals.

Overview

The Company continued a pattern of strong growth during the year ended December 31, 2005. This growth has resulted in improved operating results as compared to prior years. Key measurements for the year ended December 31, 2005 include the following:

- Total assets at December 31, 2005 increased by 23.0% to \$210.0 million as compared to \$170.8 million as of December 31, 2004.
- Net loans outstanding increased by 31.7% from \$149.2 million as of December 31, 2004 to \$196.6 million as of December 31, 2005.
- At December 31, 2005, the Company had a borrower with nonperforming loans for which a \$500,000 provision was established in the fourth quarter. We believe an appropriate allowance for credit losses continues to be maintained.
- Deposits at December 31, 2005 were \$182.6 million, an increase of \$28.6 million or 18.6% from December 31, 2004.
- On December 12, 2005, the Company participated in a private placement of \$8 million of fixed interest rate trust preferred securities through a newly formed Delaware trust subsidiary, Bay National Capital Trust I. The Company used \$2.2 million of the proceeds of the offering to repay in full the amount outstanding under its credit facility with another financial institution. The remaining proceeds will be used for general corporate purposes, including but not limited to supporting continued asset growth.

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- The Company realized net income of \$2,744,330 for the year ended December 31, 2005. This compares to net income of \$802,264 and \$7,581 for the years ended December 31, 2004 and 2003, respectively. Included in the results of the year ended December 31, 2005 was an income tax benefit of \$655,000 as we recognized our previously unrecorded net deferred income tax asset.
- Net interest income, the Company's main source of income, was \$8.7 million for the year ended December 31, 2005 compared to \$5.2 million and \$3.6 million for the years ended December 31, 2004 and 2003, respectively. This represents increases of 68.4% and 142.5% over the two prior years.
- Net loan recoveries were \$11,134 for the year ended December 31, 2005. Net charge-offs since the inception of the Bank in 2000 were \$4,961.
- Non-interest income for the year ended December 31, 2005 increased by \$211,746 or 39.3% as compared to the year ended December 31, 2004, primarily as a result of the addition of the Lutherville residential mortgage origination operation.
- Non-interest expenses increased by \$1,834,615 or 42.3% for the year ended December 31, 2005, as compared to the year ended December 31, 2004.
- The market price of common shares ended the year at \$21.00, up 58.5% from the closing price of \$13.25 on December 31, 2004.

A detailed discussion of the factors leading to these changes can be found in the discussion below.

Results of Operations

OVERVIEW

The Company recorded net income of \$2,744,330 for the year ended December 31, 2005. This compares to \$802,264 reported for the year ended December 31, 2004, an improvement of \$1,942,066. The Company reported its first annual profit of \$7,581 for the year ended December 31, 2003. This significant improvement in results for the periods is due to the continued strong growth of the loan portfolio, as well as significant improvement in margins resulting from a rising interest rate environment.

Bay National Bank's mortgage origination operations, located in Lutherville and Salisbury, Maryland, originate conventional first and second residential mortgage loans. Bay National Bank sells most of its first and second residential mortgage loans in the secondary market and typically recognizes a gain on the sale of these loans after the payment of commissions to the loan origination officer. Since its inception in February 2001, the Salisbury mortgage division has been a significant contributor to operating results. The Lutherville mortgage operation was initiated in February 2005 and began to contribute to the Company's overall profitability during the second half of 2005. For the years ended December 31, 2005, 2004 and 2003, gains on the sale of mortgage loans totaled \$512,047, \$244,716 and \$370,326, respectively.

The level of gains on the sale of mortgage loans has increased in 2005 due to the addition of the Lutherville origination operation, which focuses on construction and rehabilitation loans that will be modified to permanent financing upon completion of the project. The permanent financing is then sold in the secondary market. We believe that this type of residential lending is less sensitive to the fluctuation of interest rates.

During the second quarter of 2004, the Company introduced a new loan program for conventional first lien and second lien residential mortgage loans. Under this program, the Company purchases a 100% participation in mortgage loans originated by a mortgage company in the Baltimore metropolitan area. These participations are for loans which a

secondary market investor has committed to purchase. The participations are typically held for a period of three to four weeks before being sold to the secondary market investor. This holding period represents the amount of time taken by the secondary market investor to review the loan files for completeness and accuracy. During this holding period, the Company earns interest on these loans at a rate indexed to the prime rate.

The primary risk to the Company from this program is that the secondary market investor may decline to purchase the loans due to documentary deficiencies or errors. The Company attempts to manage this risk by conducting a thorough review of the documentation prior to purchasing the participation. If the secondary market investor declines to purchase the loan, the Company could attempt to sell the loan to other investors or hold the loan in its loan portfolio. As of December 31, 2005, the Company held \$15.5 million of these loans which were classified as held for sale. The Company expects that all of these loans will be purchased by the secondary market investor. The Company earned \$751,803 of interest on this program during 2005 and \$287,835 during 2004.

Management expects continued improvement in operating results as asset levels continue to grow. However, actual results will be subject to the volatility of the provision for credit losses, which is related to loan growth, the impact of interest rate changes, which can reduce margins, the continued success of the new Lutherville mortgage lending programs, and the volatility of existing mortgage loan production, which is sensitive to economic and interest rate fluctuations.

NET INTEREST INCOME / MARGINS

Net interest income is the difference between income on earning assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans, investments, and federal funds sold. Interest-bearing deposits and other borrowings make up the cost of funds. Non-interest bearing deposits and capital are also funding sources. Changes in the volume and mix of earning assets and funding sources along with changes in associated interest rates determine changes in net interest income.

Interest income from loans and investments for the year ended December 31, 2005 was \$12,982,706, compared to \$7,623,564 and \$5,520,068 for the years ended December 31, 2004 and 2003, respectively. The 70.3% increase over 2004, and the 135.2% increase over 2003, is directly related to the 27.8% increase in average interest earning assets from 2004, and the 68.7% increase in average interest earning assets from 2003. The change in interest income was also impacted by changes in average yields due to a rising interest rate environment in 2005 and 2004. The yields on these assets rose from 5.07% for the year ended December 31, 2003 to 5.31% for the year ended December 31, 2004 and to 7.08% for the year ended December 31, 2005.

The percentage of average interest-earning assets represented by loans was 92.5%, 88.0% and 82.5% for the years ended December 31, 2005, 2004, and 2003, respectively. For the year ended December 31, 2005, the average yield on the loan portfolio was 7.46%, as compared to 5.89% for the year ended December 31, 2004 and 5.98% for the year ended December 31, 2003. Loan yields have primarily increased as a result of thirteen 0.25% increases in the target federal funds rate, from 1.00% at June 25, 2003 to 4.25% effective December 13, 2005. As can be seen by the yields discussed above, these increases had a significant impact on the Company's operating results. The timing and amount of the impact on loan yields of changes to the federal funds rates varies from period to period as a result of differences in the mix of fixed rate loans to variable rate loans at any point in time.

The average yield on the investment portfolio and other earning assets such as federal funds sold was 2.27% for the year ended December 31, 2005 as compared to 1.11% and 0.80% for the years ended December 31, 2004 and 2003, respectively. The fluctuations in the average yields were a direct result of the Federal Reserve actions discussed above as well as an increase in the holdings of Federal Reserve and Federal Home Loan Bank of Atlanta stocks, which pay dividend yields greater than the prevailing federal funds rate. The percentage of average interest-earning assets represented by investments was 7.5%, 12.0% and 17.5% for the years ended December 31, 2005, 2004, and 2003, respectively.

Interest expense from deposits and borrowings for the year ended December 31, 2005 was \$4,294,146 compared to \$2,464,209 and \$1,936,726 for the years ended December 31, 2004 and 2003, respectively. The 74.3% increase over 2004 and the 121.7% increase over 2003 are directly related to the 27.5% increase in average interest-bearing liabilities from 2004 and the 69.2% increase in average interest-bearing liabilities from 2003. Interest expense was also impacted by changes in average rates paid due to the fluctuating interest rate environment. The average rates paid on these liabilities changed from 2.26% for the year ended December 31, 2003 to 2.17% for the year ended December 31, 2004 to 2.96% for the year ended December 31, 2005. Average rates paid increased during 2005 as a result of the rising interest rate environment during this period. Even though interest rates rose in 2004, management was able to delay raising rates, which is why average rates declined between 2003 and 2004. Management has observed pressure to increase rates paid on deposits as the target for the federal funds rate has risen. Management expects that this pressure will continue if rates continue to rise.

The following tables set forth, for the periods indicated, information regarding the average balances of interest-earning assets and interest-bearing liabilities, the amount of interest income and interest expense, and the resulting yields on average interest-earning assets and rates paid on average interest-bearing liabilities. Average balances are also provided for non-interest-earning assets and non-interest-bearing liabilities.

No tax equivalent adjustments were made and no income was exempt from federal income taxes. All average balances are daily average balances. The amortization of loan fees is included in computing interest income, however, such fees are not material.

	Year Ended December 31, 2005		
	Average Balance	Interest and fees	Yield/ Rate
ASSETS			
Loans and loans held for sale	\$ 169,811,066	\$ 12,671,707	7.46%
Investment securities	2,343,007	86,267	3.68
Federal funds sold and other overnight investments	11,340,021	224,732	1.98
Total Earning Assets	183,494,094	12,982,706	7.08%
Less: Allowance for credit losses	(2,064,604)		
Cash and due from banks	1,328,362		
Premises and equipment, net	708,549		
Accrued interest receivable and other assets	900,832		
Total Assets	\$ 184,367,233		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	\$ 56,170,562	1,064,126	1.89%
Regular savings deposits	5,643,798	36,572	.65
Time deposits	77,785,133	2,957,821	3.80
Short-term borrowings	3,630,729	115,810	3.19
Note payable	1,426,027	91,709	6.43
Subordinated debt	438,356	28,108	7.20
Total interest-bearing liabilities	145,094,605	4,294,146	2.96%
Net interest income and spread		\$ 8,688,560	4.12%
Non-interest-bearing demand deposits	24,032,958		
Accrued expenses and other liabilities	884,689		
Stockholders' equity	14,354,981		
Total Liabilities and Stockholders' Equity	\$ 184,367,233		
Interest and fee income/earning assets	7.08%		
Interest expense/earning assets	2.34		
Net interest margin	4.74%		
Return on Average Assets	1.49%		
Return on Average Equity	19.12%		
Average Equity to Average Assets	7.79%		

	Year Ended December 31, 2004		
	Average Balance	Interest and fees	Yield/ Rate
ASSETS			
Loans and loans held for sale	\$ 126,212,414	\$ 7,431,368	5.89%
Investment securities	2,038,432	45,173	2.22
Federal funds sold and other overnight investments	15,232,288	147,023	0.97
Total Earning Assets	143,483,134	7,623,564	5.31%
Less: Allowance for credit losses	(1,473,985)		
Cash and due from banks	909,590		
Premises and equipment, net	641,550		
Accrued interest receivable and other assets	534,261		
Total Assets	\$ 144,094,550		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	\$ 46,627,122	509,308	1.09%
Regular savings deposits	4,363,244	28,396	0.65
Time deposits	61,184,843	1,901,183	3.11
Short-term borrowings	1,475,148	19,020	1.29
Note payable	129,098	6,302	4.88
Subordinated debt	-	-	-
Total interest-bearing liabilities	113,779,445	2,464,209	2.17%
Net interest income and spread		\$ 5,159,355	3.14%
Non-interest-bearing demand deposits	17,391,401		
Accrued expenses and other liabilities	515,639		
Stockholders' equity	12,408,055		
Total Liabilities and Stockholders' Equity	\$ 144,094,550		
Interest and fee income/earning assets	5.31%		
Interest expense/earning assets	1.71		
Net interest margin	3.60%		
Return on Average Assets	0.56%		
Return on Average Equity	6.47%		
Average Equity to Average Assets	8.61%		

Year Ended December 31, 2003

	Average Balance	Interest and fees	Yield/ Rate
ASSETS			
Loans and loans held for sale	\$ 89,721,871	\$5,367,997	5.98%
Investment securities	1,833,052	37,317	2.04
Federal funds sold and other overnight investments	17,238,474	114,754	0.67
Total Earning Assets	108,793,397	5,520,068	5.07%
Less: Allowance for credit losses	(1,090,526)		
Cash and due from banks	903,675		
Premises and equipment, net	689,080		
Accrued interest receivable and other assets	396,583		
Total Assets	\$ 109,692,209		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	\$ 33,884,963	381,985	1.13%
Regular savings deposits	2,997,371	20,532	0.69
Time deposits	47,675,682	1,522,525	3.19
Short-term borrowings	1,172,658	11,684	1.00
Subordinated debt	-	-	-
Total interest-bearing liabilities	85,730,674	1,936,726	2.26%
Net interest income and spread		\$3,583,342	2.81%
Non-interest-bearing demand deposits	13,158,325		
Accrued expenses and other liabilities	386,732		
Stockholders' equity	10,416,478		
Total Liabilities and Stockholders' Equity	\$ 109,692,209		
Interest and fee income/earning assets		5.07%	
Interest expense/earning assets		1.78	
Net interest margin		3.29%	
Return on Average Assets	-	%	
Return on Average Equity	-	%	
Average Equity to Average Assets	9.50%		

RATE/VOLUME ANALYSIS

A rate/volume analysis, which demonstrates changes in taxable-equivalent interest income and expense for significant assets and liabilities, appears below. The calculation of rate, volume and rate/volume variances is based on a procedure established for bank holding companies by the Securities and Exchange Commission. Rate, volume and rate/volume variances presented for each component may not total to the variances presented on totals of interest income and interest expense because of shifts from year to year in the relative mix of interest-earning assets and interest-bearing liabilities.

	Year ended December 31, 2005 vs. 2004 Due to variances in			
	Total	Rates	Volumes	Rate/ Volume
Interest earned on:				
Loans and loans held for sale	\$5,240,339	\$ 1,986,904	\$ 2,567,082	\$ 686,353
Investment Securities	41,094	29,880	6,749	4,465
Federal funds sold and other overnight investments	77,709	154,844	(37,568)	(39,567)
Total interest income	5,359,142	2,171,628	2,536,263	651,251
Interest paid on:				
Interest-bearing demand deposits	554,818	374,022	104,243	76,553
Regular savings deposits	8,176	(122)	8,334	(36)
Time deposits	1,056,638	425,403	515,817	115,418
Short-term borrowings	96,790	28,033	27,793	40,964
Note payable	85,407	2,001	63,310	20,096
Subordinated debt	28,108	-	-	28,108
Total interest expense	1,829,937	829,337	719,497	281,103
Net interest earned	\$3,529,205	\$ 1,342,291	\$ 1,816,766	\$ 370,148

	Year ended December 31, 2004 vs. 2003 Due to variances in			
	Total	Rates	Volumes	Rate/ Volume
Interest earned on:				
Loans and loans held for sale	\$2,063,371	\$ (85,187)	\$ 2,183,204	\$ (34,646)
Investment Securities	7,856	3,305	4,181	370
Federal funds sold and other overnight investments	32,269	51,633	(13,355)	(6,009)
Total interest income	2,103,496	(30,249)	2,174,030	(40,285)
Interest paid on:				
Interest-bearing demand deposits	127,323	(11,860)	143,642	(4,459)

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Regular savings deposits	7,864	(1,025)	9,356	(467)
Time deposits	378,658	(41,109)	431,416	(11,649)
Short-term borrowings	7,336	3,436	3,014	886
Note payable	6,302	-	-	6,302
Subordinated Debt	-	-	-	-
Total interest expense	527,483	(50,558)	587,428	(9,387)
Net interest earned	\$1,576,013	\$ 20,309	\$ 1,586,602	\$ (30,898)

PROVISION FOR CREDIT LOSSES

The provision for credit losses was \$1,178,866 for the year ended December 31, 2005, as compared to \$559,596 for the year ended December 31, 2004, and \$415,000 for the year ended December 31, 2003. The provisions for each year were the direct result of growth in loan balances outstanding in all segments of the portfolio. In addition, the provision for 2005 was higher than the prior years due to the fact that the Company established a reserve of approximately \$88,000 against loans held for sale to reflect the additional risk associated with loans originated through a third party mortgage company and an additional \$500,000 provision was established in the fourth quarter of 2005 as a result of the downgrading of one credit. For additional information regarding the methodology used to determine the provision for credit losses see the Management Discussion and Analysis section entitled "Allowance for Credit Losses and Credit Risk Management."

NON-INTEREST INCOME

Non-interest income consists primarily of gains on the sale of mortgage loans, deposit account service charges and cash management fees. For the year ended December 31, 2005, the Company realized non-interest income in the amount of \$750,593 as compared to \$538,847 and \$625,263 for the years ended December 31, 2004 and 2003, respectively.

Gains on the sale of mortgage loans of \$512,047 represented 68.22% of non-interest income for the year ended December 31, 2005. This compares to gains on the sale of mortgage loans of \$244,716 or 45.42% of total non-interest income for the year ended December 31, 2004 and \$370,326 or 59.23% of total non-interest income for the year ended December 31, 2003. The level of gains on the sale of mortgage loans has increased because the Company added additional residential construction and mortgage capabilities with the opening of the Lutherville mortgage operation in February 2005. This was achieved through the hiring of a team of eight individuals, including originators, processors and servicers who have extensive experience in the industry and the Company's market area. It is expected that these additional capabilities will increase future levels of gains on the sale of mortgage loans, while also providing interest and fee income on construction loans. However, additional increases in interest rates, or a slow down in the housing market, could impact the Company's ability to generate non-interest income associated with mortgage loan production.

Service charges on deposit accounts totaled \$188,276 for the year ended December 31, 2005, as compared to \$237,980 and \$212,787 for the years ended December 31, 2004 and 2003, respectively. The decreases of 20.9% over 2004 and 11.5% over 2003 can be directly attributed to a decline in analysis fees charged on commercial deposit accounts. This decline occurred as the rate used for the calculation of analysis credits increased in conjunction with the increase in the target federal funds rate discussed earlier. Analysis credits are fee reductions provided based upon the analysis credit rate and the average balance of the account subject to analysis fees.

The Company will continue to seek ways to expand its sources of non-interest income. In the future, the Company may enter into fee arrangements with strategic partners that offer investment advisory services, risk management and employee benefit services. No assurance can be given that such fee arrangements will be obtained or maintained.

NON-INTEREST EXPENSE

The components of non-interest expense were as follows:

	Years Ended December 31,		
	2005	2004	2003
Salaries and employee benefits	\$ 3,627,630	\$ 2,442,774	\$ 2,115,351
Occupancy expenses	420,866	312,550	259,719
Furniture and equipment expenses	304,132	255,547	215,254
Legal and professional fees	154,476	175,757	158,406
Data processing and other outside services	655,726	582,396	536,433
Advertising and marketing related expenses	445,482	212,237	210,289
Other expenses	562,645	355,081	290,572
Total non-interest expenses	\$ 6,170,957	\$ 4,336,342	\$ 3,786,024

2005 compared to 2004

Non-interest expense for the year ended December 31, 2005 totaled \$6,170,957 compared to \$4,336,342 for the year ended December 31, 2004. The increase of \$1,834,615, or 42.3%, was primarily due to increases in salaries and employee benefit expenses, occupancy expenses, data processing and other outside services, advertising and marketing related expenses, furniture and equipment expenses and other expenses.

Salaries and benefits increased by \$1,184,856 or 48.5% as a result of staffing growth related to the addition of the Lutherville mortgage operation as well as staffing to increase marketing efforts, manage the growth of the loan and deposit portfolios and support increased operational volume. Occupancy expenses increased by \$108,316, or 34.7%, due in part to scheduled rent increases and increased rental expenses associated with new space obtained to facilitate the expansion of the Company's corporate offices and to accommodate the new Lutherville mortgage lending group.

The \$73,330, or 12.6%, increase in data processing and other outside services resulted from increased data and item processing costs paid to external service providers. The costs include one-time expenses of approximately \$45,000 incurred in conjunction with the Bank's planned change of core processors that occurred in May 2005, approximately \$24,000 of recruiting fees paid to hire additional staff, and approximately \$8,000 of systems support costs incurred to facilitate network infrastructure changes required for a bank processing system upgrade. The costs associated with purchasing additional hardware and software to support increased staffing were offset by savings on the new core processing contract, which provides for lower unit costs on a volume driven pricing structure.

The \$48,585, or 19.0%, increase in furniture and equipment expenses is related to increased costs associated with expanded staffing and facilities. Advertising and marketing related expenses increased \$233,245, or 109.9%, which was related to an increase in the number of marketing events conducted and the number of business development professionals as well as a total of \$125,000 increase in funds set aside for charitable contributions to the Baltimore Community Foundation Donor Advised Fund and the Community Foundation of the Eastern Shore Donor Advised Fund established by the Bank. The increase of \$186,283, or 35.1%, in all other expenses relates to various costs associated with the increased size and complexity of the Company.

The banking industry utilizes the "efficiency ratio" as a key measure of expense management and overall operating efficiency. This ratio is computed by dividing non-interest expense by the sum of net interest income before the loan loss provision and non-interest income. The Company's efficiency ratio was 65.4% for the year ended December 31, 2005 compared to 76.1% for the year ending December 31, 2004. The improved ratio from the prior year was driven by strong revenue growth and prudent management of the Company's cost structure.

The rate of increase in non-interest expenses is substantially less than the 68.4% increase in net interest income for the year ended December 31, 2005 as compared to the year ended December 31, 2004. Management believes this indicates that the Company is continuing to effectively leverage its cost structure to generate profitable growth. While management expects that the ongoing growth of the Company's customer base will continue to require additional staffing in order to appropriately service customers and manage the business effectively, management believes that additional growth in the customer base can continue to be accomplished without proportionate increases in these costs.

Substantially all of the occupancy costs are paid to directors of Bay National Corporation or entities controlled by directors of Bay National Corporation. Management believes that the terms of these leases are at least as favorable as could be obtained from independent third parties. However, management has not conducted a recent market analysis to confirm this fact. For a discussion of the terms of the leases with these persons, see "Item 12 - Certain Relationships and Related Transactions."

2004 compared to 2003

Non-interest expense for the year ended December 31, 2004 totaled \$4,336,342 compared to \$3,786,024 for the year ended December 31, 2003. The increase of \$550,318, or 14.54%, was primarily due to increases in salaries and employee benefit expenses, occupancy expenses, data processing and other outside services, furniture and equipment expenses and other expenses.

Salaries and benefits increased by \$327,423 or 15.48% as a result of staffing growth initiated to increase marketing efforts, manage the growth of the loan and deposit portfolios and support increased operational volume. Occupancy expenses increased by \$52,831, or 20.34% due in part to scheduled rent increases as well as a reduction in sublease income of approximately \$10,900 due to expansion of the Company's corporate office into previously sublet space and \$20,400 of rental expenses associated with new space obtained to facilitate the expansion of the Company's corporate offices. The \$45,963, or 8.57%, increase in data processing and other outside services resulted from increased data and item processing costs paid to external service providers. These costs are volume-driven based upon the number of customer accounts and related transaction volume. As a result, these costs increase with the growth of the Company. The \$40,293, or 18.72%, increase in furniture and equipment expenses is related to increased costs associated with expanded staffing and facilities. The increase of \$83,808, or 12.71%, in all other expenses relates to various costs associated with the increased size and complexity of the Company.

The Company's efficiency ratio was 76.10% for the year ended December 31, 2004 compared to 89.96% for the year ending December 31, 2003. The improved ratio from the prior year was driven by strong revenue growth and prudent management of the Company's cost structure.

INCOME TAXES

For the year ended December 31, 2005, the Company will be required to pay income taxes for the first time in its brief history. The Company incurred a current income tax liability of \$428,000 for the year ended December 31, 2005.

For financial reporting purposes, taxable income for the years ended December 31, 2004 and 2003 was offset by the Company's net operating loss carryforwards available in those years. The 2005 liability was offset by the recognition of a deferred tax asset of \$1,083,000, resulting in a net tax benefit of \$655,000 for the year ended December 31, 2005.

The use of the net operating loss carryforward and the recognition of net deferred income tax assets had a positive effect on 2005 earnings. In subsequent periods, the Company will begin to record income tax expense at the statutory rate. Prior to 2005, the Company had not recorded any income tax expense or benefit. Recognizing income tax expense in future periods will have a detrimental effect on reported earnings.

At December 31, 2005, the Company continues to have approximately \$886,000 of Maryland net operating loss carryforwards (a possible net tax benefit on \$62,000) for the unconsolidated state tax return for Bay National Corporation. Unless Bay National Corporation generates income from its own operations (i.e., unrelated to Bay National Bank), these operating loss carryforwards will expire in 2019 and 2020.

Financial Condition

COMPOSITION OF THE BALANCE SHEET

Total assets of the Company were \$209,966,335 as of December 31, 2005, compared to total assets of \$170,763,474 as of December 31, 2004. This represents growth of approximately \$39.2 million, or 23%, since December 31, 2004. The growth in assets was funded by growth in deposits, earnings and issuance of \$8.0 million in subordinated debt. Deposits at December 31, 2005 were \$182,573,086 as compared to deposits of \$153,927,042 at December 31, 2004. Deposit growth resulted from the marketing efforts of officers and directors of the Bank and the use of two Internet based listing services for certificates of deposit. Management has set the interest rates paid on deposits to be competitive in the market and has continued to increase marketing activities throughout the year.

As of December 31, 2005, loans including loans held for sale (net of a \$3,000,000 allowance for credit losses), totaled \$196,589,961. This represents an increase of \$47,373,362, or 31.7%, from December 31, 2004. The composition of the loan portfolio as of December 31, 2005 was approximately \$75.6 million of commercial loans (excluding real estate loans), \$2.9 million of consumer loans and \$103.6 million of real estate loans excluding \$17,509,064 of mortgage loans held for sale. The composition of the loan portfolio as of December 31, 2004 was approximately \$73.8 million of commercial loans (excluding real estate loans), \$2.2 million of consumer loans and \$65.4 million of real estate loans excluding \$9,613,162 of mortgage loans held for sale. Growth in the loan portfolio is a direct result of the addition of the Lutherville mortgage group as well as the marketing efforts of bank employees, members of the Board of Directors and the Baltimore and Salisbury Advisory Boards. The mix of loans shifted to a higher concentration in real estate as a result of the Lutherville mortgage group's production and the strength of the overall real estate market. -

The Company continues to emphasize prudent growth through the hiring of experienced commercial lenders and the development and use of referral sources including accountants, lawyers and existing customers, as well as members of the Board of Directors and the Baltimore and Salisbury Advisory Boards.

Funds not extended in loans are held in cash and due from banks, and various investments including federal funds sold and other overnight investments, United States Treasury securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. These investments totaled \$9,828,447 as of December 31, 2005 compared to \$20,212,538 as of December 31, 2004. Other than the investments in Federal Reserve Bank stock and Federal Home Loan Bank stock, totaling \$794,440 and \$556,090 at December 31, 2005 and 2004, respectively, all investments have maturities of 90 days or less. The Treasury securities are used to collateralize repurchase agreements which are classified as short-term borrowings under which \$916,158 and \$1,381,000 were outstanding as of December 31, 2005 and December 31, 2004, respectively. Management has made a decision to maintain liquidity in the investment portfolio in order to ensure that funds are readily available to fund the growth of the loan portfolio.

As of December 31, 2004, the Company had borrowed \$1,250,000 under a \$5 million, three-year unsecured non-revolving credit facility executed on September 28, 2004 with another financial institution. Borrowings under the credit facility were used to provide regulatory capital to the Bank. The loan bore interest at the prime rate as offered by the financial institution. On December 12, 2005, the Company used \$2.2 million of proceeds from the private placement of \$8 million of fixed interest rate trust preferred securities to repay in full the amount outstanding under its credit facility with this financial institution. The trust preferred securities bear interest at a rate of 7.2% and mature on February 23, 2036. These securities are redeemable at the Company's option at par beginning on February 23, 2011. The remaining proceeds will be used for general corporate purposes including supporting asset growth.

Total capital at December 31, 2005 was \$16,214,078 as compared to \$13,418,764 at December 31, 2004. The increase in capital is primarily a result of the positive operating results for the year ended December 31, 2005.

COMPOSITION OF LOAN PORTFOLIO

Because yields on loans typically exceed the yields on investments, the Company's business strategy is to continue to increase the overall level of loans, as well as maintain a relatively high percentage of loans to total earning assets. Increasing loans and loans as a percentage of total earning assets will maximize the net interest margin. As of December 31, 2005 and 2004, loans represented 95.98% and 89.19% of total earning assets, respectively.

The following table sets forth the composition of the principal balances of the Company's loan portfolio as of December 31, 2005, 2004, 2003, 2002, and 2001, respectively.

	2005	2004	2003	2002	2001
Real Estate - Home Equity Line of Credit	\$ 21,067,964	\$ 24,548,506	\$ 16,078,166	\$ 9,960,943	\$ 5,641,198
Real Estate - Construction	25,719,603	12,968,251	8,101,017	3,700,389	2,230,067
Real Estate - Mortgage	56,757,096	27,854,130	13,687,709	7,816,997	2,448,595
Loans Held for Sale	17,509,064	9,613,162	923,825	2,818,500	682,000
Commercial	75,626,825	73,836,994	61,868,002	42,566,165	23,488,566
Consumer	2,909,409	2,205,556	1,657,081	4,033,767	2,053,629
Total Loans	\$ 199,589,961	\$ 151,026,599	\$ 102,315,800	\$ 70,896,761	\$ 36,544,055

The following table sets forth the percentages of loans in each category for the Company's loan portfolio as of December 31, 2005, 2004, 2003, 2002, and 2001, respectively.

	2005	2004	2003	2002	2001
Real Estate - Home Equity Line of Credit	10.55%	16.25%	15.71%	14.05%	15.44%
Real Estate - Construction	12.89	8.59	7.92	5.22	6.10
Real Estate - Mortgage	28.44	18.44	13.38	11.03	6.70
Loans Held for Sale	8.77	6.37	.90	3.97	1.87
Commercial	37.89	48.89	60.47	60.04	64.27
Consumer	1.46	1.46	1.62	5.69	5.62
Total Loans	100.00%	100.00%	100.00%	100.00%	100.00%

The following table sets forth the maturity distribution for the Company's loan portfolio at December 31, 2005. Some of the loans may be renewed or repaid prior to maturity. Therefore, the following table should not be used as a forecast of future cash flows.

	Within one year	One to three years	Three to five years	Over five years
Real Estate - Home Equity Line of Credit	\$ 21,067,964	\$ -	\$ -	\$ -
Real Estate - Construction	22,692,415	3,027,188	-	-
Real Estate - Mortgage	44,345,737	5,434,758	6,161,436	815,165
Loans Held for Sale	17,509,064	-	-	-
Commercial	62,423,877	8,406,625	4,619,805	176,518
Consumer	2,796,489	101,441	11,479	-
Total	\$ 170,835,546	\$ 16,970,012	\$ 10,792,720	\$ 991,683
Fixed interest rate	\$ 37,968,824	\$ 16,970,012	\$ 10,792,720	\$ 991,683

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Variable interest rate	115,357,658	-	-	-
Loans Held for Sale	17,509,064	-	-	-
Total	\$170,835,546	\$16,970,012	\$ 10,792,720	\$ 991,683

The scheduled repayments as shown above are reported in the maturity category in which the payment is due, except for the adjustable rate loans, which are reported in the period of repricing.

The Company's loan portfolio composition as of December 31, 2005 reflects a 57.80% concentration in variable rate loans. Loans held for sale total \$17,509,064 or 10.25% of the Company's loan portfolio. Fixed rate loans total \$66,723,239 or 33.43% of the Company's loan portfolio. Interest rates on variable rate loans adjust to the current interest rate environment, whereas fixed rates do not allow this flexibility. Loans held for sale are expected to be sold in three months or less and as a result are not materially impacted by interest rate fluctuations. If interest rates were to increase in the future, the interest earned on the variable rate loans would improve, and, if rates were to fall, the interest earned would decline. See "Liquidity and Interest Rate Sensitivity."

The officers and directors of the Company had outstanding loans from the Bank of \$8,059,647 at December 31, 2005 and \$5,828,095 at December 31, 2004. All loans made to officers and directors are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unaffiliated third parties and do not involve more than the normal risk of repayment or present other unfavorable features.

ALLOWANCE FOR CREDIT LOSSES AND CREDIT RISK MANAGEMENT

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the type of loans being made, the credit-worthiness of the borrowers over the term of the loans, the quality of the collateral for the loan, if any, as well as general economic conditions. The Company charges the provision for credit losses to earnings to maintain the total allowance for credit losses at a level considered by management to represent its best estimate of the losses known and inherent in the portfolio that are both probable and reasonable to estimate, based on, among other factors, prior loss experience, volume and type of lending conducted, estimated value of any underlying collateral, economic conditions (particularly as such conditions relate to the Company's market area), regulatory guidance, peer statistics, management's judgment, past due loans in the loan portfolio, loan charge off experience and concentrations of risk (if any). The Company charges losses on loans against the allowance when it is believed that collection of loan principal is unlikely. Recoveries on loans previously charged off are added back to the allowance.

Management uses a loan grading system where all loans are graded based on management's evaluation of the risk associated with each loan. A factor, based on the loan grading, is applied to the loan balance to reserve for potential losses. In addition, management judgmentally establishes an additional nonspecific reserve. The nonspecific portion of the allowance reflects management's estimate of probable inherent but undetected losses within the portfolio due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition, the difficulty in identifying triggering events that correlate perfectly to subsequent loss rates and risk factors that have not yet manifested themselves in loss allocation factors.

The reserve factors used are based on management's judgment as to appropriate reserve percentages for various categories of loans, and adjusts those values based on the following: historical losses in each category, historical and current delinquency in each category, underwriting standards in each category, comparison of losses and delinquencies to peer group performance and an assessment of the likely impact of economic and other external conditions on the performance of each category.

A test of the adequacy of the allowance for credit losses is performed and reported to the Board of Directors on a monthly basis. Management uses the information available to make a determination with respect to the allowance for credit losses, recognizing that the determination is inherently subjective and that future adjustments may be necessary depending upon, among other factors, a change in economic conditions of specific borrowers or generally in the economy and new information that becomes available. However, there are no assurances that the allowance for credit losses will be sufficient to absorb losses on nonperforming assets or that the allowance will be sufficient to cover

losses on nonperforming assets in the future.

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The allowance for credit losses as of December 31, 2005 and December 31, 2004 was \$3,000,000 and \$1,810,000, respectively. The amount equates to 1.50% and 1.20% of outstanding loans, including loans held for sale, as of December 31, 2005 and 2004, respectively. The increased percentage was due to the fact that the Company established a reserve of approximately \$88,000 against loans held for sale to reflect the additional risk associated with loans originated through a third party mortgage company and an additional \$500,000 provision established in the fourth quarter of 2005 as a result of the downgrading of one credit. Bay National Corporation has no exposure to foreign countries or foreign borrowers. Management believes that the allowance for loan losses is adequate for each period presented.

The following table represents an analysis of the activity in the allowance for credit losses for the periods presented:

	2005	2004	2003	2002	2001
Balance at beginning of year	\$ 1,810,000	\$ 1,266,500	\$ 851,500	\$ 447,000	\$ 70,000
Provision for credit losses	1,178,866	559,596	415,000	404,500	377,000
Loan charge-offs					
Commercial	-	(15,222)	-	-	-
Consumer	-	(2,134)	-	-	-
Loan recoveries					
Commercial	11,134	1,260	-	-	-
Net recoveries (charge-offs)	11,134	(16,096)	-	-	-
Balance at end of year	\$ 3,000,000	\$ 1,810,000	\$ 1,266,500	\$ 851,500	\$ 447,000

The following table presents the allocation of the allowance for credit losses, reflecting use of the methodology presented above for the periods presented:

	2005	2004	Amount 2003	2002	2001
Real Estate - Home Equity	\$ 106,986	\$ 122,918	\$ 80,370	\$ 52,720	\$ 30,987
Line of Credit					
Real Estate - Construction	347,092	150,346	86,252	33,961	23,551
Real Estate - Mortgage	306,577	179,798	133,109	84,548	27,069
Loans Held for Sale	87,545	48,066	-	-	-
Commercial	2,046,219	1,279,472	954,623	626,699	244,308
Consumer	10,275	11,032	10,324	26,256	8,811
Unallocated	95,306	18,368	1,822	27,316	112,274
Total Allowance	\$ 3,000,000	\$ 1,810,000	\$ 1,266,500	\$ 851,500	\$ 447,000

The unallocated portion of the allowance for credit losses increased in 2005. This occurred because the Company calculates an overall reserve level while the underlying portfolio experienced a moderate shift in the mix of loans by risk grade. The shift in the mix of loans by risk grade is a normal result of the addition of new loans, the decrease in balances of more mature loans and the ongoing reassessment of all loans.

The following table sets forth the percentages of loans in each category for the Company's loan portfolio as of December 31, 2005, 2004, 2003, 2002, and 2001, respectively.

	2005	2004	2003	2002	2001
Real Estate - Home Equity Line of Credit	10.55%	16.25%	15.71%	14.05%	15.44%
Real Estate - Construction	12.89	8.59	7.92	5.22	6.10
Real Estate - Mortgage	28.44	18.44	13.38	11.03	6.70
Loans Held for Sale	8.77	6.37	.90	3.97	1.87

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Commercial	37.89	48.89	60.47	60.04	64.27
Consumer	1.46	1.46	1.62	5.69	5.62
Total Loans	100.00%	100.00%	100.00%	100.00%	100.00%

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NONPERFORMING LOANS AND OTHER DELINQUENT ASSETS

Management performs reviews of all delinquent loans. Management will generally classify loans as non-accrual when collection of full principal and interest under the original terms of the loan is not expected or payment of principal or interest has become 90 days past due. Classifying a loan as non-accrual results in the Company no longer accruing interest on such loan and reversing any interest previously accrued but not collected. A non-accrual loan may be restored to accrual status when delinquent principal and interest payments are brought current and future monthly principal and interest payments are expected to be collected. The Company will recognize interest on non-accrual loans only when received. As of December 31, 2005 and 2004, the Company did not have any non-accrual loans.

Any property acquired by the Company as a result of foreclosure on a mortgage loan will be classified as "real estate owned" and will be recorded at the lower of the unpaid principal balance or fair value at the date of acquisition and subsequently carried at the lower of cost or net realizable value. Any required write-down of the loan to its net realizable value will be charged against the allowance for credit losses. Upon foreclosure, the Company generally will require an appraisal of the property and, thereafter, appraisals of the property on at least an annual basis with external inspections on at least a quarterly basis. As of December 31, 2005, and December 31, 2004, the Company held no real estate acquired as a result of foreclosure.

The Company applies the provisions of Statements of Financial Accounting Standards No. 114 ("SFAS No. 114"), "Accounting by Creditors for Impairment of a Loan," as amended by Statements of Financial Accounting Standards No. 118 ("SFAS No. 118"), "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosure." SFAS No. 114 and SFAS No. 118 require that impaired loans, which consist of all modified loans and other loans for which collection of all contractual principal and interest is not probable, be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, an impairment is recognized through a valuation allowance and corresponding provision for credit losses. The Company considers consumer loans as homogenous loans and thus does not apply the SFAS No. 114 impairment test to these loans. Impaired loans will be written off when collection of the loan is doubtful.

The Company had no impaired loans as of December 31, 2004, 2003, 2002 and 2001, respectively. As of December 31, 2005, the Company, based on information obtained subsequent to year-end, deemed loans to one borrower, with a net principal balance of \$1,708,874, as impaired due to the obligor's financial difficulties. Accordingly, a \$500,000 provision against the allowance for credit losses was established in the fourth quarter of 2005 for the downgrading of this credit. A loan to this borrower, with a net principal balance of \$1,238,041, was classified as non-accrual as of January 1, 2006, the amount of accrued interest being considered immaterial. The Company has subsequently received approximately \$537,000 that was applied against this loan and full payment on a related loan, resulting in a net principal balance of \$700,237. Collection of the remainder is uncertain. Management believes that the allowance for credit losses is adequate.

INVESTMENT PORTFOLIO

The Company has chosen to invest its available funds primarily in federal funds sold and other overnight investments. As a result, investment securities as of December 31, 2005, consisted of \$452,340 of Federal Reserve Bank stock, \$342,100 of Federal Home Loan Bank stock and \$1,540,386 of U.S. Treasury securities which mature within three months. Investment securities for the year ended December 31, 2004, consisted of \$312,690 of Federal Reserve Bank stock, \$243,400 of Federal Home Loan Bank stock and \$1,544,496 of U.S. Treasury securities which matured within three months. Investment securities for the year ended December 31, 2003 consisted of \$312,690 of Federal Reserve Bank stock, \$168,400 of Federal Home Loan Bank stock and \$1,547,798 of U.S. Treasury securities which matured within three months.

Management has made the decision to maintain its available funds in highly liquid assets because it wishes to ensure that funds are readily available to fund the growth of the loan portfolio. Management believes that this strategy will allow the Company to maximize interest margins while maintaining appropriate levels of liquidity to fund loan growth.

SOURCES OF FUNDS

General

Deposits, short-term borrowings in the form of repurchase agreements, short-term borrowings under secured and unsecured lines of credit, borrowings under the subordinated debt, scheduled amortization and prepayment of loans, funds provided by operations and capital are the current sources of funds utilized by the Company for lending and investment activities, and other general business purposes.

Deposits

The Company offers a variety of deposit products having a range of interest rates and terms. The Company's deposits consist of checking accounts, savings accounts, money market accounts and certificates of deposit.

The following table sets forth the composition of the Company's deposits as of December 31, 2005 and December 31, 2004:

		<u>2005</u>		<u>2004</u>	
Demand Deposits	\$ 61,057,678	33.44%	\$ 52,121,451	33.86%	
Savings	9,215,092	5.05	5,255,422	3.41	
Money Market and sweep	19,411,421	10.63	28,304,367	18.39	
Certificates of deposit	92,888,895	50.88	68,245,802	44.34	
Total deposits	\$182,573,086	100.00%	\$153,927,042	100.00%	

The mix of deposits has remained relatively steady from year to year. The decrease in the percentage of deposits represented by money market and sweep accounts is due primarily to a decrease in balances held for one large customer, as well as movement of funds to certificates of deposit as depositors seek higher yields.

Of the total deposits at December 31, 2005, \$12.0 million, or 6.56%, were related to two customers in one industry and a third customer in another industry as compared to \$16.6 million, or 10.79%, at December 31, 2004. The deposits for these customers tend to fluctuate significantly; as a result, management monitors these deposits on a daily basis to ensure that liquidity levels are adequate to compensate for these fluctuations.

The following table sets forth the maturity distribution for the Company's deposits at December 31, 2005. Some of the deposits may be renewed or withdrawn prior to maturity. Therefore, the following table should not be used as a forecast of future cash flows.

	Within one year	One to three years	Three to five years	Over five years
Demand deposits	\$ 61,057,678	\$ -	\$ -	\$ -
Savings	9,215,092	-	-	-
Money Market and sweep	19,411,421	-	-	-
Certificates of deposit	49,419,719	26,427,778	17,041,398	-
Total	\$139,103,910	\$26,427,778	\$17,041,398	\$ -

Certificates of deposit in amounts of \$100,000 or more, and their remaining maturities at December 31, 2005, are as follows:

Three months or less	\$ 4,374,777
Over three months through six months	11,163,966
Over six months through twelve months	6,400,569
Over twelve months	15,072,324
Total	\$37,011,636

The market in which the Company operates is very competitive and the rates of interest paid on deposits are affected by rates paid by other depository institutions. Management closely monitors rates offered by other institutions and seeks to be competitive within the market. The Company has chosen to selectively compete for large certificates of deposits. The Company will choose to pursue such deposits when expected loan growth provides for adequate spreads to support the cost of those funds. As of December 31, 2005, the Company had outstanding certificates of deposit of approximately \$33.8 million that were obtained through the listing of certificate of deposit rates on two Internet-based listing services. These certificates of deposit were issued with an average yield of 4.10% and an average term of 28 months. Included in the \$33.8 million of Internet-originated certificates of deposit is one certificate of deposit in the amount of \$97,296 that has been classified as a “Brokered Deposit” for bank regulatory purposes. This “Brokered Deposit” was issued with a yield of 2.75% and matures in October 2006. As of December 31, 2004, the total certificates of deposit obtained through the listing of certificate of deposit rates on the Internet-based listing services was approximately \$29 million, of which \$394,666 were classified as “Brokered Deposits.” The Company has never paid broker fees for deposits and has not accepted any new “Brokered Deposits” since August 2002.

Core deposits, which management categorizes as all deposits other than national market certificates of deposit and all but \$5.0 million of deposits from the three large customers described above (which management considers to be a stable deposit amount from these customers based upon historical trends), stood at \$141,825,926 as of December 31, 2005, up 25.05% from \$113,412,507 as of December 31, 2004. Core deposits are closely monitored by management because they consider such deposits not only a relatively stable source of funding but also reflective of the growth of commercial and consumer depository relationships.

Borrowings.

On September 28, 2004, the Company entered into a five million, three year unsecured non-revolving credit facility with Drovers Bank of York, Pennsylvania, a division of Fulton Bank. The loan paid interest at the prime rate as offered by Drovers Bank. The credit facility was scheduled to expire on September 28, 2007, at which time all outstanding amounts under the credit facility, including accrued but unpaid interest, would have become due and payable. The Company had the option to repay interest and principal under the credit facility at any time without premium or penalty.

In December 2005, the Company used \$2.2 million of the proceeds from the private placement of \$8 million of fixed interest rate trust preferred securities to repay in full the amount outstanding under its credit facility with Drovers Bank as further described below.

On December 12, 2005, the Company participated in a private placement of \$8 million of fixed interest rate trust preferred securities (the “Trust Preferred Securities”), through a newly formed Delaware trust subsidiary, Bay National Capital Trust I (the “Trust”). The Trust was formed for the purpose of issuing the Trust Preferred Securities and all of its common securities are owned by the Company. The Company purchased the common securities from the Trust for \$248,000. In accordance with provisions of FIN46, the financial position and results of operations are not included in the Company’s consolidated financial position and results of operations.

The Trust used the proceeds of the sale of the Trust Preferred Securities and common securities to purchase from the Company the aggregate principal amount of \$8,248,000 of the Company's Fixed Rate Junior Subordinated Debt Securities Due 2036 (the "Debt Securities"). Like the Trust Preferred Securities, the Debt Securities bear interest at the fixed annual rate of 7.20% until maturity. The interest expense on Trust Preferred Securities was \$28,108 in 2005. The Debt Securities mature on February 23, 2036, but may be redeemed at the Company's option at any time on any February 23, May 23, August 23 or November 23 on or after February 23, 2011, or at any time upon certain events, such as a change in the regulatory capital treatment of Debt Securities, the Trust being deemed to be an "investment company" under the Investment Company Act of 1940, as amended, or the occurrence of certain adverse tax events. Except upon the occurrence of the events described above, which require a redemption premium for redemptions prior to February 23, 2011, the Company may redeem the Debt Securities at their aggregate principal amount, plus accrued interest, if any.

The Parent is required to retain \$1,000,000 of the proceeds from the Debt Securities for general corporate purposes (which may include making interest payments on the Debt Securities) until the earlier of (i) the date on which the retained funds are reduced to zero, or (ii) the date on which Bay National Bank (or any successor) meets the statutory requirements to pay dividends of at least \$148,464 for each of two consecutive quarters with positive retained earnings remaining after any such dividend payment.

The Debt Securities are subordinated to the prior payment of other indebtedness of the Company that, by its terms, are not similarly subordinated. Although the Debt Securities are recorded as a liability on the Company's balance sheet, for regulatory purposes, the Debt Securities are being treated as Tier 1 or Tier 2 capital under regulatory capital guidelines issued by the Federal Reserve Board.

Short-term borrowings as of December 31, 2005 consist of advances under unsecured Federal Funds lines of credit of \$528,000 and repurchase agreements collateralized by pledges of U.S. Government Treasury Securities, based upon their market values, equal to 100% of the principal and accrued interest of the repurchase agreements. The outstanding balance of repurchase agreements decreased from \$1,381,000 at December 31, 2004 to \$916,158 at December 31, 2005, due to decreases in the balance of available funds for customers participating in this program.

As of December 31, 2005, the Company maintained commitments for a total of \$9.0 million of borrowing availability under unsecured Federal Funds lines of credit with three separate financial institutions. The Company also had approximately \$21.0 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of December 31, 2005.

INTEREST RATE SENSITIVITY

The primary objective of asset/liability management is to ensure the steady growth of the Company's primary earnings component, net interest income. Net interest income can fluctuate with significant interest rate movements. To minimize the risk associated with these rate swings, management works to structure the Company's balance sheet so that the ability exists to adjust pricing on interest-earning assets and interest-bearing liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these repricing opportunities at any point in time constitute interest rate sensitivity.

The measurement of the Company's interest rate sensitivity, or "gap," is one of the principal techniques used in asset/liability management. The interest sensitive gap is the dollar difference between assets and liabilities which are subject to interest rate pricing within a given time period, including both floating rate or adjustable rate instruments, and instruments which are approaching maturity.

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The following table sets forth the amount of the Company's interest-earning assets and interest-bearing liabilities as of December 31, 2005, which are expected to mature or reprice in each of the time periods shown:

	Amount	Percent of Total	Maturity or repricing within			
			0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years
Interest-earning assets						
Federal funds sold and other overnight investments	\$ 6,032,952	2.90%	\$ 6,032,952	\$ -	\$ -	\$ -
Loans held for sale	17,509,064	8.42	17,509,064	-	-	-
Investment securities available for sale	1,540,386	0.74	1,540,386	-	-	-
Loans - Variable rate	115,357,658	55.47	115,357,658	-	-	-
Loans - Fixed rate	66,723,239	32.09	3,978,062	33,990,762	27,762,732	991,683
Other earning assets	794,440	0.38	-	-	-	794,440
Total interest-earning assets	\$207,957,739	100.00%	\$144,418,122	\$33,990,762	\$ 27,762,732	\$ 1,786,123
Interest-bearing liabilities						
Deposits - Variable rate	\$ 62,215,434	37.81%	\$ 62,215,434	\$ -	\$ -	\$ -
Deposits - Fixed rate	92,888,895	56.45	8,127,549	41,192,170	43,569,176	-
Short-term borrowings	9,444,158	5.74	1,444,158	-	-	8,000,000
Total interest-bearing liabilities	\$164,548,486	100.00%	\$ 71,787,141	\$41,192,170	\$ 43,569,176	\$ 8,000,000
Periodic repricing differences						
Periodic gap			\$ 72,630,981	\$ (7,201,408)	\$ (15,806,444)	\$ (6,213,877)
Cumulative gap			\$ 72,630,981	\$ 65,429,573	\$ 49,623,129	\$ 43,409,252
Ratio of rate sensitive assets to rate sensitive liabilities						
				%		
			201.18%	82.52	63.72%	22.33%

The Company has 66.79% of its interest-earning assets and 38.69% of its interest-bearing liabilities in variable rate balances. The excess of interest-earning assets over interest-bearing liabilities of \$65,429,573 in the categories of items maturing or repricing within 12 months comprises the majority of the overall gap. This gap is generally reflective of the Company's emphasis on originating variable rate loans and the demand in the market for higher yielding fixed rate deposits. This analysis indicates that the Company generally will benefit from rising market rates of interest. However, since all interest rates and yields do not adjust at the same pace, the gap is only a general indicator of interest rate sensitivity. The analysis of the Company's interest-earning assets and interest-bearing liabilities presents only a static view of the timing of maturities and repricing opportunities, without taking into

consideration the fact that changes in interest rates do not affect all assets and liabilities equally. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Management constantly monitors and manages the structure of the Company's balance sheet, seeks to control interest rate exposure and evaluate pricing strategies. Strategies to better match maturities of interest-earning assets and interest-bearing liabilities include structuring loans with rate floors and ceilings on variable rate notes and by providing for repricing opportunities on fixed rate notes. Management believes that a lending strategy focusing on variable rate loans and short-term fixed rate loans will best facilitate the goal of minimizing interest rate risk. However, management will opportunistically enter into longer term fixed rate loans and/or investments when, in management's judgment, rates adequately compensate the Company for the interest rate risk. The Company's current investment concentration in federal funds sold and other overnight investments provides the most flexibility and control over rate sensitivity since it generally can be restructured more quickly than the loan portfolio. On the liability side, deposit products can be restructured so as to offer incentives to attain the maturity distribution desired although competitive factors sometimes make control over deposit maturity difficult.

In theory, maintaining a nominal level of interest rate sensitivity can diminish interest rate risk. In practice, this is made difficult by a number of factors, including cyclical variation in loan demand, different impacts on interest sensitive assets and liabilities when interest rates change and the availability of funding sources. Management generally attempts to maintain a balance between rate-sensitive assets and liabilities as the exposure period is lengthened to minimize the overall interest rate risk to the Company.

LIQUIDITY

The Company's overall asset/liability strategy takes into account the need to maintain adequate liquidity to fund asset growth and deposit runoff. Management monitors the liquidity position daily.

The Company's primary sources of funds are deposits, short-term borrowings in the form of repurchase agreements, borrowings under the Federal funds and Federal Home Loan Bank credit facilities, scheduled amortization and prepayment of loans, funds provided by operations and capital. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competition.

The Company's most liquid assets are cash and assets that can be readily converted into cash, including investment securities maturing within one year. As of December 31, 2005, the Company had \$1,460,669 in cash and due from banks, \$6,032,952 in federal funds sold and other overnight investments and \$1,540,386 in three-month U.S. Treasury Securities. As of December 31, 2004, the Company had \$1,403,424 in cash and due from banks, \$16,708,528 in federal funds sold and other overnight investments and \$1,544,496 in three-month U.S. Treasury Securities.

The decline in the overall level of liquid assets is the result of an ongoing effort by management to maximize net interest margins by utilizing liquidity to fund loans. This is made possible by preserving available liquidity in the Federal funds and Federal Home Loan Bank credit facilities. Growth in the Company's loan portfolio, without corresponding growth in deposits, would reduce liquidity, as would reductions in the level of customer deposits.

During 2005, the Company maintained commitments for a total of \$9.0 million of borrowing availability under unsecured Federal funds lines of credit with three separate financial institutions. The Company also has approximately \$21 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of December 31, 2005. These credit facilities can be used in conjunction with the normal deposit strategies, which include pricing changes to increase deposits as necessary. From time to time, the Company may sell or participate out loans to create additional liquidity as required.

The Company has sufficient liquidity to meet its loan commitments as well as fluctuations in deposits. The Company will seek to retain maturing certificates of deposit, when necessary, by offering competitive rates.

Management is not aware of any known trends, events or uncertainties that will have or are reasonably likely to have a material effect on our liquidity, capital or operations, nor are we aware of any current recommendation by regulatory authorities, which if implemented, would have a material effect on liquidity, capital or operations.

CONTRACTUAL OBLIGATIONS, COMMITMENTS, CONTINGENT LIABILITIES, AND OFF-BALANCE SHEET ARRANGEMENTS

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business. These financial instruments primarily include commitments to extend credit, lines of credit and standby letters of credit. The Company uses these financial instruments to meet the financing needs of its customers. These financial instruments involve, to varying degrees, elements of credit, interest rate and liquidity risk. In addition, the Company also has operating lease obligations and purchase commitments.

Outstanding loan commitments and lines and letters of credit at December 31 of 2005 and 2004 are as follows:

	2005	2004
Loan commitments	\$21,577,585	\$ 9,867,893
Unused lines of credit	41,317,927	40,423,986
Letters of credit	2,754,383	1,578,379

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 interest rates fixed at current market amounts, fixed expiration dates or other termination clauses and may require payment of a fee. Unused lines of credit represent the unused portion of lines of credit previously extended and available to the customer as long as there is no violation of any contractual condition. These lines generally have variable interest rates. Since many of the commitments are expected to expire without being drawn upon, and since it is unlikely that customers will draw upon their line of credit in full at any time, the total commitment amount or line of credit amount does not necessarily represent future cash requirements. The Company is not aware of any loss it would incur by funding its commitments or lines of credit.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. The Company's exposure to credit loss in the event of nonperformance by the customer is the contract amount of the commitment.

In general, loan commitments, lines of credit and letters of credit are made on the same terms, including with respect to collateral, as outstanding loans. Each customer's credit-worthiness and the collateral required are evaluated on a case-by-case basis.

The increase in the overall level of loan commitments and unused lines of credit as of December 31, 2005 as compared to loan commitments and unused lines of credit as of December 31, 2004, is a direct result of the same marketing activities that resulted in the 32.2% increase in outstanding loans.

The Company has various financial obligations, including contractual obligations and commitments that may require future cash payments.

The following table presents, as of December 31, 2005, significant fixed and determinable contractual obligations to third parties by payment date.

	Within one year	One to three years	Three to five years	Over five years
Deposits without a stated maturity(a)	\$ 89,689,099	\$ -	\$ -	\$ -
Certificates of deposit(a)	49,776,317	26,427,778	17,041,398	-
Other borrowings	1,444,158	-	-	8,000,000
Operating leases	375,073	781,740	461,745	-
Purchase obligations	313,732	362,166	301,805	-
Total	\$ 141,598,379	\$ 27,571,684	\$ 17,804,948	\$ 8,000,000

(a) Includes accrued interest payable.

The Company's operating lease obligations represent short and long-term lease and rental payments for facilities. Purchase obligations represent estimated obligations under agreements to purchase goods or services that are enforceable and legally binding on the Company. The purchase obligation amounts presented above primarily relate to estimated obligations under data and item processing contracts and accounts payable for goods and services received through December 31, 2005.

CAPITAL RESOURCES

The Company had stockholders' equity at December 31, 2005 of \$16,214,078 as compared to \$13,418,764 at December 31, 2004. The increase in capital is a result of the positive operating results. The Company has declared no cash dividends since its inception.

Banking regulatory authorities have implemented strict capital guidelines directly related to the credit risk associated with an institution's assets. Banks and bank holding companies are required to maintain capital levels based on their "risk adjusted" assets so that categories of assets with higher "defined" credit risks will require more capital support than assets with lower risks. The Bank has exceeded its capital adequacy requirements to date.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agencies. Regulatory approval is required to pay dividends that exceed the Bank's net profits for the current year plus its retained net profits for the preceding two years. The Bank could not have paid dividends to the Company without approval from bank regulatory agencies at December 31, 2005.

The tables below present the Bank's capital position relative to its various minimum regulatory capital requirements as of December 31, 2005, and 2004. For a discussion of these capital requirements, see "Item 1 Description of Business - Supervision and Regulation - Bay National Bank - Capital Adequacy Guidelines."

December 31, 2005

	Actual		For Capital Adequacy Purpose		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):	\$21,668,568	10.21%	\$16,675,000	8.00%	\$20,843,000	10.00%
Tier I Capital (to Risk Weighted Assets):	18,668,568	8.96%	8,337,000	4.00%	12,506,000	6.00%
Tier I Capital (to Average Assets):	18,668,568	9.15%	6,124,000	3.00%	10,206,000	5.00%

December 31, 2004

	Actual		For Capital Adequacy Purpose		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):	\$16,242,797	10.32%	\$12,592,000	8.00%	\$15,740,000	10.00%
Tier I Capital (to Risk Weighted Assets):	14,432,797	9.17%	6,296,000	4.00%	9,444,000	6.00%
Tier I Capital (to Average Assets):	14,432,797	8.98%	4,821,000	3.00%	8,034,000	5.00%

Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of the Company's operations. Unlike most industrial companies, nearly all the assets of the Company are monetary in nature. As a result, interest rates have a greater impact on the Company's performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods and services.

Reconciliation of Non-GAAP Measures

Below is a reconciliation of total deposits to core deposits as of December 31, 2005 and December 31, 2004, respectively:

	December 31, 2005	December 31, 2004
Total deposits	\$ 182,573,086	\$ 153,927,042
National market certificates of deposit	(33,765,135)	(28,908,592)
Variable balance accounts (3 customers in 2005 and 2004)	(11,982,025)	(16,605,943)
Portion of variable balance accounts considered to be core	5,000,000	5,000,000
Core deposits	\$ 141,825,926	\$ 113,412,507

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Application of Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability must be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for credit losses as the accounting area that requires the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

The allowance for credit losses represents management's best estimate of losses known and inherent in the loan portfolio that are both probable and reasonable to estimate, based on, among other factors: prior loss experience of the Company and peer institutions; current economic conditions; review of the ongoing financial conditions of borrowers; and the views of the Company's regulators and the firm that conducts an annual independent loan review. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant estimates, assumptions and judgments. The loan portfolio also represents the largest asset type on the consolidated balance sheets.

The Company uses a loan grading system where loans are graded based on management's evaluation of the risk associated with each loan. A factor, based on the loan grading, is applied to the loan balance to reserve for losses. In addition, management judgmentally establishes an additional nonspecific reserve. The nonspecific portion of the allowance reflects management's estimate of probable inherent but undetected losses within the portfolio due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition, the difficulty in identifying triggering events that correlate perfectly to subsequent loss rates and risk factors that have not yet manifested themselves in loss allocation factors.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses, including the valuation of collateral and the financial condition of the borrower, and in establishing allowance percentages and risk ratings. The establishment of allowance factors is a continuing exercise and allowance factors may change over time, resulting in an increase or decrease in the amount of the provision or allowance based upon the same volume and classification of loans.

Changes in allowance factors or in management's interpretation of those factors will have a direct impact on the amount of the provision and a corresponding effect on income and assets. Also, errors in management's perception and

assessment of the allowance factors could result in the allowance not being adequate to cover losses in the portfolio and may result in additional provisions or charge-offs, which would adversely affect income and capital. For additional information regarding the allowance for loan and lease losses, see the “Provision for Credit Losses and Credit Risk Management” section of this financial review.

Recent Accounting Pronouncements And Developments

In December 2004, the FASB revised SFAS 123, "Accounting for Stock-Based Compensation." SFAS 123R establishes accounting requirements for share-based compensation to employees and carries forward prior guidance on accounting for awards to non-employees. The provisions of this statement will become effective January 1, 2006 for non-accelerated filers for all equity awards vesting after the effective date. SFAS 123R requires an entity to recognize compensation expense based on an estimate of the number of awards expected to actually vest, exclusive of awards expected to be forfeited. At December 31, 2005, the total value of options outstanding and vesting after January 1, 2006 is expected to be approximately \$119,000, with \$87,000 (before the consideration of income taxes, if any) vesting in the year ending December 31, 2006.

Note 1 to the consolidated financial statements discusses SFAS 123R and other new accounting policies adopted by the Company during 2005 and the expected impact of accounting policies, recently issued or proposed, but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects the Company's financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this financial review and notes to the consolidated financial statements.

Risk Management

The Board of Directors is the foundation for effective corporate governance and risk management. The Board demands accountability of management, keeps stockholders' and other constituencies' interests in focus and fosters a strong internal control environment. Through its Executive, Asset/Liability and Audit Committees, the Board actively reviews critical risk positions, including market, credit, liquidity and operational risk. The Company's goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk and ensure appropriate returns for risk assumed. Senior management actively manages risk at the line of business level, supplemented with corporate-level oversight through the Asset/Liability Committee, the internal audit process and quality control functions and other risk management groups within the Company. This risk management structure is designed to uncover risk issues through a systematic process, enabling timely and appropriate action to avoid and mitigate risk. The risk management process establishes risk limits and other measurement systems, with a focus on risk reduction strategies and capital allocation practices.

Item 7. Financial Statements

The following consolidated financial statements are filed with this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2005 and 2004

Consolidated Statements of Operations - For the years ended December 31, 2005, 2004 and 2003

Consolidated Statements of Changes in Stockholders' Equity - For the years ended December 31, 2005, 2004 and 2003

Consolidated Statements of Cash Flows - For the years ended December 31, 2005, 2004 and 2003

Notes to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Bay National Corporation

We have audited the accompanying consolidated balance sheets of Bay National Corporation and subsidiary (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bay National Corporation and subsidiary as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

/s/ Stegman & Company
Baltimore, Maryland
January 17, 2006

BAY NATIONAL CORPORATION
CONSOLIDATED BALANCE SHEETS
December 31, 2005 and 2004

	2005	2004
ASSETS		
Cash and due from banks	\$ 1,460,669	\$ 1,403,424
Federal funds sold and other overnight investments	6,032,952	16,708,528
Investment securities available for sale (AFS) - at fair value	1,540,386	1,544,496
Other equity securities	794,440	556,090
Loans held for sale	17,509,064	9,613,162
Loans, net of unearned fees	182,080,897	141,413,437
Total Loans	199,589,961	151,026,599
Less: Allowance for credit losses	(3,000,000)	(1,810,000)
Loans, net	196,589,961	149,216,599
Premises and equipment, net	746,826	593,583
Accrued interest receivable and other assets	2,801,101	740,754
 Total Assets	 \$ 209,966,335	 \$ 170,763,474
 LIABILITIES		
Non-interest-bearing deposits	\$ 27,468,757	\$ 20,638,596
Interest-bearing deposits	155,104,329	133,288,446
Total deposits	182,573,086	153,927,042
 Short-term borrowings	 1,444,158	 1,381,000
Note payable	-	1,250,000
Subordinated debt	8,000,000	-
Accrued expenses and other liabilities	1,735,013	786,668
 Total Liabilities	 193,752,257	 157,344,710
 STOCKHOLDERS' EQUITY		
Common stock - \$.01 par value, authorized: 9,000,000 shares authorized, 1,924,436 and 1,917,710 issued and outstanding as of December 31, 2005 and 2004, respectively:	19,244	19,177
Additional paid in capital	17,451,201	17,400,284
Accumulated deficit	(1,256,367)	(4,000,697)
 Total Stockholders' Equity	 16,214,078	 13,418,764
 Total Liabilities and Stockholders' Equity	 \$ 209,966,335	 \$ 170,763,474

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
For the years ended December 31, 2005, 2004 and 2003

	2005		2004		2003
INTEREST INCOME:					
Interest and fees on loans	\$ 12,671,707	\$	7,431,368	\$	5,367,997
Interest on federal funds sold and other overnight investments	224,732		147,023		114,754
Taxable interest and dividends on investment securities	86,267		45,173		37,317
Total interest income	12,982,706		7,623,564		5,520,068
INTEREST EXPENSE:					
Interest on deposits	4,058,519		2,438,887		1,925,042
Interest on short-term borrowings	115,810		19,020		11,684
Interest on note payable	91,709		6,302		-
Interest on subordinated debt	28,108		-		-
Total interest expense	4,294,146		2,464,209		1,936,726
Net interest income	8,688,560		5,159,355		3,583,342
Provision for credit losses	1,178,866		559,596		415,000
Net interest income after provision for credit losses	7,509,694		4,599,759		3,168,342
NON-INTEREST INCOME:					
Service charges on deposit accounts	188,276		237,980		212,787
Gain on sale of mortgage loans	512,047		244,716		370,326
Other income	50,270		56,151		42,150
Total non-interest income	750,593		538,847		625,263
NON-INTEREST EXPENSE:					
Salaries and employee benefits	3,627,630		2,442,774		2,115,351
Occupancy expenses	420,866		312,550		259,719
Furniture and equipment expenses	304,132		255,547		215,254
Legal and professional fees	154,476		175,757		158,406
Data processing and other outside services	655,726		582,396		536,433
Advertising and marketing related expenses	445,482		212,237		210,289
Other expenses	562,645		355,081		290,572
Total non-interest expenses	6,170,957		4,336,342		3,786,024
Income before income taxes	2,089,330		802,264		7,581
Income tax benefit	655,000		-		-
Net Income	\$ 2,744,330	\$	802,264	\$	7,581
Per Share Data:					
Net Income (Basic)	\$ 1.43	\$.43	\$.00
Net Income (Diluted)	\$ 1.37	\$.41	\$.00
Average Shares Outstanding (Basic)	1,922,580		1,877,929		1,660,348

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Effect of dilution - Stock options and Warrants	79,645	58,764	22,557
Average Shares Outstanding (Diluted)	2,002,225	1,936,693	1,682,905

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the years ended December 31, 2005, 2004 and 2003

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Total
Balances at December 31, 2002	\$ 12,420	\$ 12,407,780	\$ (4,810,542)	\$ 7,609,658
Issuance of Common Stock	6,207	4,443,054	-	4,449,261
Net Income	-	-	7,581	7,581
Balances at December 31, 2003	18,627	16,850,834	(4,802,961)	12,066,500
Issuance of Common Stock	550	549,450	-	550,000
Net Income	-	-	802,264	802,264
Balances at December 31, 2004	19,177	17,400,284	(4,000,697)	13,418,764
Issuance of Common Stock	67	50,917	-	50,984
Net Income	-	-	2,744,330	2,744,330
Balances at December 31, 2005	\$ 19,244	\$ 17,451,201	\$ (1,256,367)	\$ 16,214,078

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2005, 2004 and 2003

	2005		2004		2003
Cash Flows From Operating Activities:					
Net Income	\$ 2,744,330	\$	802,264	\$	7,581
Adjustments to reconcile net income to net cash provided (used) by operating activities:					
Depreciation	193,196		204,204		189,858
Loss on disposal of equipment	203		17,018		-
Accretion of investment discounts	(46,539)		(19,251)		(14,804)
Provision for credit losses	1,178,866		559,596		415,000
Deferred income taxes	(1,083,000)		-		-
Gain on sale of loans held for sale	(512,047)		(244,716)		(370,326)
Origination of loans held for sale	(217,744,320)		(108,988,138)		(35,629,285)
Proceeds from sale of loans	210,360,465		100,543,517		37,894,286
Net increase in accrued interest receivable and other assets	(977,347)		(188,403)		(117,569)
Net increase in accrued expenses and other liabilities	948,345		277,813		95,061
Net cash (used) provided by operating activities	(4,937,848)		(7,036,096)		2,469,802
Cash Flows From Investing Activities:					
Purchases of investment securities	(6,149,351)		(6,177,447)		(6,284,633)
Maturities of investment securities	6,200,000		6,200,000		5,700,000
Purchase of Federal Reserve Bank stock	(139,650)		-		(36,750)
Purchase of Federal Home Loan Bank of Atlanta stock	(98,700)		(75,000)		(88,500)
Loan disbursements in excess of principal payments	(40,656,326)		(40,037,558)		(33,313,714)
Expenditures for premises and equipment	(346,642)		(177,193)		(118,267)
Net cash used by investing activities	(41,190,669)		(40,267,198)		(34,141,864)
Cash Flows From Financing Activities:					
Net increase in deposits	28,646,044		45,396,141		32,452,170
Net increase in short-term borrowings	63,158		159,000		715,000
Net payoff (proceeds) from notes payable	(1,250,000)		1,250,000		-
Proceeds from subordinated debt	8,000,000		-		-
Net proceeds from issuance of common stock	50,984		550,000		4,449,261
Net cash provided by financing activities	35,510,186		47,355,141		37,616,431
Net (decrease) increase in cash and cash equivalents	(10,618,331)		51,847		5,944,369
Cash and cash equivalents at beginning of year	18,111,952		18,060,105		12,115,736
Cash and cash equivalents at end of year	\$ 7,493,621	\$	18,111,952	\$	18,060,105
Cash paid for:					
Interest	\$ 4,128,414	\$	2,366,155	\$	1,926,169
Income taxes	\$ -	\$	-	\$	-

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

Notes to Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Bay National Corporation and its subsidiary, Bay National Bank (the "Bank"), collectively (the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. The investment in subsidiary is recorded on the parent's books on the basis of its equity in the net assets. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices in the banking industry.

Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2005.

Nature of Business

Bay National Corporation was incorporated on June 3, 1999 under the laws of the State of Maryland to operate as a bank holding company of a national bank with the name Bay National Bank. On May 12, 2000, the Company purchased all the shares of common stock issued by the Bank. The Company's operations through that date were limited to taking the necessary actions to organize and capitalize the Company and the Bank. The Bank commenced operations on May 12, 2000 after successfully meeting the conditions of the Office of the Comptroller of the Currency (the "OCC") to receive its charter authorizing it to commence operations as a national bank, obtaining the approval of the Federal Deposit Insurance Corporation to insure its deposit accounts and meeting certain other regulatory requirements.

The principal business of the Company is to make loans and other investments and to accept time and demand deposits. The Company's primary market areas are Baltimore and Salisbury, Maryland, although the Company's business development efforts generate business outside of these areas. The Company offers a broad range of banking products, including a full line of business and personal savings and checking accounts, money market demand accounts, certificates of deposit and other banking services. The Company funds a variety of loan types including commercial and residential real estate loans, commercial term loans and lines of credit, consumer loans and letters of credit. The Company's customers are primarily individuals and small businesses.

Use of Estimates

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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company has included cash and due from banks, and federal funds sold and other overnight investments as cash and cash equivalents for the purpose of reporting cash flows.

BAY NATIONAL CORPORATION

Notes to Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

Investments Available-for-Sale and Other Equity Securities

Marketable equity securities and debt securities, not classified as held-to-maturity or trading, are classified as available-for-sale. Securities available-for-sale are acquired as part of the Company's asset/liability management strategy and may be sold in response to changes in interest rates, loan demand, changes in prepayment risk and other factors. Securities available-for-sale are carried at fair value, with unrealized gains or losses based on the difference between amortized cost and fair value reported as accumulated other comprehensive income, a separate component of stockholders' equity, net of deferred tax. Realized gains and losses, using the specific identification method, are included as a separate component of non-interest income. Related interest and dividends are included in interest income. Declines in the fair value of individual available-for-sale securities below their cost, that are other than temporary, result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or the fact that management would not have the intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value.

Other equity securities represented by Federal Reserve Bank and Federal Home Loan Bank of Atlanta stock are considered restricted as to marketability.

Loans Held for Sale

The Company engages in sales of residential mortgage loans originated by the Bank and by a third party. Loans held for sale are carried at the lower of aggregate cost or fair value. Fair value is derived from secondary market quotations for similar instruments. Gains and losses on sales of the loan originated by the Bank are recorded as a component of non-interest income in the accompanying consolidated statements of operations. No gains or losses are realized on the sale of loans originated by third parties. The Company's current practice is to sell loans on a servicing released basis, and, therefore, it has no intangible asset recorded for the value of such servicing at either December 31, 2005 or December 31, 2004. The Company earns interest on the outstanding balances of all loans that are held for sale.

Loans

Loans are stated at the principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate on the principal amount outstanding. It is the Company's policy to discontinue the accrual of interest when circumstances indicate that collection is doubtful. Fees charged and costs capitalized for originating certain loans are amortized on the interest method over the term of the loan.

Loans are considered impaired when, based on current information, it is improbable that the Company will collect all principal and interest payments according to contractual terms. Generally, loans are considered impaired once principal and interest payments are 90 days past due and they are placed on non-accrual. Management also considers the financial condition of the borrower, cash flows of the loan and the value of the related collateral. Impaired loans do not include large groups of smaller balance homogeneous credits such as residential real estate, consumer installment loans and commercial leases, which are evaluated collectively for impairment. Loans specifically reviewed for impairment are not considered impaired during periods of "minimal delay" in payment (usually ninety days or less) provided eventual collection of all amounts due is expected. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, the Company may measure impairment based on a loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. The Company recognizes interest income on impaired loans on a cash basis if the borrower demonstrates the ability to meet the contractual obligation and collateral is sufficient. If there is doubt

regarding the borrower's ability to make payments, or if the collateral is not sufficient, payments received are accounted for as a reduction in principal.

BAY NATIONAL CORPORATION

Notes to Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

Allowance for Credit Losses

The allowance for credit losses is established through a provision for credit losses charged to expense. Loans are charged against the allowance for credit losses when management believes that the collectibility of the principal is unlikely. The allowance, based on evaluations of the collectibility of loans, is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible. 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 and trends that may affect the borrowers' ability to pay.

The allowance for credit losses represents an estimation done pursuant to either Statement of Financial Accounting Standards ("SFAS") No. 5 "Accounting for Contingencies" or SFAS No. 114 "Accounting by Creditors for Impairment of a Loan." The Company uses a loan grading system where loans are graded based on management's evaluation of the risk associated with each loan. A factor, based on the loan grading, is applied to the loan balance to reserve for losses. In addition, management judgmentally establishes an additional nonspecific reserve. The nonspecific portion of the allowance reflects management's estimate of probable inherent, but undetected, losses within the portfolio due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition, the difficulty in identifying triggering events that correlate perfectly to subsequent loss rates and risk factors that have not yet manifested themselves in loss allocation factors. The adequacy of the allowance is determined through careful and continuous evaluation of the credit portfolio and involves consideration of a number of factors to establish a prudent level. Determination of the allowance is inherently subjective and requires significant estimates, including estimated losses on pools of homogeneous loans based on historical loss experience and consideration of current economic trends, which may be susceptible to significant change.

While management believes it has established the allowance for credit losses in accordance with generally accepted accounting principles and has taken into account the views of its regulators and the current economic environment, there can be no assurance that in the future the Company's regulators or the economic environment will not require further increases in the allowance.

Rate Lock Commitments

The Company enters into commitments to originate residential mortgage loans with interest rates determined prior to funding. Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally range from 15 to 90 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Company commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Company is not exposed to losses nor will it realize gains related to its rate lock commitments due to changes in interest rates.

BAY NATIONAL CORPORATION

Notes to Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization computed using the straight-line method. Premises and equipment are depreciated over the useful lives of the assets, except for leasehold improvements which are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Useful lives range from: five to ten years for furniture, fixtures and equipment; and three to five years for software, hardware and data handling equipment. Leasehold improvements are amortized over the term of the respective lease plus the first optional renewal period, if applicable. Maintenance and repairs are charged to expense as incurred, while improvements, which extend the useful life, are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived depreciable assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset based on a quoted market price, if applicable, or a discounted cash flow analysis.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company; (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

BAY NATIONAL CORPORATION

Notes to Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

Stock-Based Compensation

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), and applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock option plan. Compensation expense for stock option awards is disclosed as a pro forma income adjustment, ratably recognized over the vesting period, based on the fair value of the stock on the date of grant under SFAS No. 123 and SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure."

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants during the year ended December 31:

	2002
Dividend yield	-
Expected volatility	20.00%
Risk-free interest rate	4.17%
Expected lives (in years)	8

No compensation expenses related to the Company's stock option plan was recorded during the years ended December 31, 2005, 2004 and 2003. The following table illustrates the pro-forma effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the years ending December 31:

	2005	2004	2003
Net income as reported	\$ 2,744,330	\$ 802,264	\$ 7,581
Less pro forma stock-based compensation expense determined under the fair value method, net of related tax effects	(102,382)	(92,474)	(84,163)
Pro forma net income (loss)	\$ 2,641,948	\$ 709,790	\$ (76,582)
Net income (loss) per share:			
Basic - as reported	\$ 1.43	\$.43	\$ (.00)
Diluted - as reported	\$ 1.37	\$.41	\$ (.00)
Basic - pro forma	\$ 1.37	\$.38	\$ (.05)
Diluted - pro forma	\$ 1.32	\$.37	\$ (.05)

Advertising Costs

Advertising costs are generally expensed as incurred.

Income Taxes

The Company uses the liability method of accounting for income taxes. Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases

of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates in effect when these differences reverse.

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Earnings Per Share

Earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding such as options and warrants. For the year ended December 31, 2003 there were 56,250 shares excluded from the diluted net income per share computation because the exercise price exceeded the average market price and therefore, their effect would be anti-dilutive.

New 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." SOP 03-3 requires acquired loans, including debt securities, to be recorded at the amount of the purchaser's initial investment and prohibits carrying over valuation allowances from the seller for those individually-evaluated loans that have evidence of deterioration in credit quality since origination, and it is probable all contractual cash flows on the loan will be unable to be collected. SOP 03-3 also requires the excess of all undiscounted cash flows expected to be collected at acquisition over the purchaser's initial investment to be recognized as interest income on a level-yield basis over the life of the loan. Subsequent increases in cash flows expected to be collected are recognized prospectively through an adjustment of the loan's yield over its remaining life, while subsequent decreases are recognized as impairment. Loans carried at fair value, mortgage loans held for sale, and loans to borrowers in good standing under revolving credit agreements are excluded from the scope of SOP 03-3. The guidance is effective for loans acquired in fiscal years beginning after December 15, 2004 and is not expected to have a material impact on financial condition, results of operations, or liquidity.

In December 2004, the FASB issued SFAS 153, "Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29," Accounting for Nonmonetary Transactions. This statement amends the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged and more broadly provides for exceptions regarding exchanges of nonmonetary assets that do not have commercial substance. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this standard is not expected to have a material impact on financial condition, results of operations, or liquidity.

In December 2004, the FASB revised SFAS 123, "Accounting for Stock-Based Compensation." SFAS 123R establishes accounting requirements for share-based compensation to employees and carries forward prior guidance on accounting for awards to non-employees. The provisions of this statement will become effective January 1, 2006 for non-accelerated filers for all equity awards vesting after the effective date. SFAS 123R requires an entity to recognize compensation expense based on an estimate of the number of awards expected to actually vest, exclusive of awards expected to be forfeited. At December 31, 2005, the total value of options outstanding and vesting after January 1, 2006 is expected to be approximately \$119,000, with \$87,000 (before the consideration of income taxes, if any) vesting in the year ending December 31, 2006.

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In May 2005, the FASB issued SFAS 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3." This statement establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. Previously, most changes in accounting principle were recognized by including the cumulative effect of changing to the new accounting principle in net income of the period of the change. Under SFAS 154, retrospective application requires (i) the cumulative effect of the change to the new accounting principle on periods prior to those presented to be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented, (ii) an offsetting adjustment, if any, to be made to the opening balance of retained earnings (or other appropriate components of equity) for that period, and (iii) financial statements for each individual prior period presented to be adjusted to reflect the direct period-specific effects of applying the new accounting principle. Special retroactive application rules apply in situations where it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Indirect effects of a change in accounting principle are required to be reported in the period in which the accounting change is made. SFAS 154 carries forward the guidance in APB Opinion 20 "Accounting Changes," requiring justification of a change in accounting principle on the basis of preferability. SFAS 154 also carries forward without change the guidance contained in APB Opinion 20, for reporting the correction of an error in previously issued financial statements and for a change in an accounting estimate. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect SFAS 154 will significantly impact its financial statements upon its adoption on January 1, 2006.

In November 2005, the FASB issued Staff Position (FSP) No. 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." FSP 115-1 provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss should be recognized equal to the difference between the investment's cost and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," while retaining the disclosure requirements of EITF 03-1 which were adopted in 2003. FSP 115-1 is effective for reporting periods beginning after December 15, 2005. The Company does not expect FSP 115-1 will significantly impact its financial statements upon its adoption on January 1, 2006.

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2. INVESTMENT SECURITIES**Investments available-for-sale**

The amortized cost and estimated fair values of investments available-for-sale at December 31, 2005 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities	\$ 1,540,386	\$ -	\$ -	\$ 1,540,386
Total investments available-for-sale	\$ 1,540,386	\$ -	\$ -	\$ 1,540,386

The amortized cost and estimated fair values of investments available-for-sale at December 31, 2005 by contractual maturity are shown below.

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 1,540,386	\$ 1,540,386
Total investments available-for-sale	\$ 1,540,386	\$ 1,540,386

The amortized cost and estimated fair values of investments available-for-sale at December 31, 2004 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities	\$ 1,544,496	\$ -	\$ -	\$ 1,544,496
Total investments available-for-sale	\$ 1,544,496	\$ -	\$ -	\$ 1,544,496

The amortized cost and estimated fair values of investments available-for-sale at December 31, 2004 by contractual maturity are shown below.

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 1,544,496	\$ 1,544,496
Total investments available-for-sale	\$ 1,544,496	\$ 1,544,496

There were no sales of investments available-for-sale during 2005, 2004 or 2003.

At December 31, 2005 and 2004, investments available-for-sale with a carrying value of \$916,158 and \$1,381,000, respectively, were pledged as collateral for certain short-term borrowings.

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Notes to Consolidated Financial Statements

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Other equity securities

At December 31, the Company's investment in other equity securities consisted of:

	2005	2004
Federal Reserve Bank stock	\$ 452,340	\$ 312,690
Federal Home Loan Bank stock	342,100	243,400
Total investments in other equity securities	\$ 794,440	\$ 556,090

3. LOANS AND ALLOWANCE FOR CREDIT LOSSES

Major loan categories at December 31 are presented below:

	2005	2004
Real Estate - Home Equity Line of Credit	\$ 21,067,964	\$ 24,548,506
Real Estate - Construction	25,719,603	12,968,251
Real Estate - Mortgage	56,757,096	27,854,130
Loans Held for Sale	17,509,064	9,613,162
Commercial	75,626,825	73,836,994
Consumer	2,909,409	2,205,556
Total Loans	199,589,961	151,026,599
Less: Allowance for credit losses	(3,000,000)	(1,810,000)
Net Loans	\$ 196,589,961	\$ 149,216,599

Activity in the allowance for credit losses for the year ended December 31, 2005, 2004 and 2003 is shown below:

	2005	2004	2003
Balance at beginning of year	\$ 1,810,000	\$ 1,266,500	\$ 851,500
Provision for credit losses	1,178,866	559,596	415,000
Loan charge-offs			
Commercial	-	(15,222)	-
Consumer	-	(2,134)	-
Loan recoveries			
Commercial	11,134	1,260	-
Net recoveries (charge-offs)	11,134	(16,096)	-
Balance at end of year	\$ 3,000,000	\$ 1,810,000	\$ 1,266,500

As of December 31, 2003, there was one non-accrual loan of \$4,087, and as of December 31, 2005, loans to one borrower, with a net principal balance of \$1,708,874, were considered impaired under SFAS No. 114 for which a \$500,000 reserve was established in the fourth quarter of 2005.

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4. PREMISES AND EQUIPMENT

Premises and equipment at December 31 include the following:

	2005	2004
Furniture and equipment	\$ 520,944	\$ 404,269
Computer hardware and software	602,550	511,369
Leasehold improvements	475,943	338,157
	1,599,437	1,253,795
Less accumulated depreciation	(852,611)	(660,212)
Net premises and equipment	\$ 746,826	\$ 593,583

The Company rents office space in three locations under two non-cancelable lease arrangements and one monthly rental agreement accounted for as operating leases. The initial lease periods are from one to five years and provide for one or more one to five-year renewal options. The lease for the Baltimore location provides for percentage annual rent escalations. The lease for the Salisbury location requires that the lessee pay certain operating expenses applicable to the leased space.

Rent expense applicable to operating leases, for the periods ended December 31, was as follows:

	2005	2004	2003
Minimum rentals	\$330,406	\$241,097	\$202,720
Less: Sublease rentals	(23,657)	(12,930)	(23,843)
Net rent expense	\$306,749	\$228,167	\$178,877

At December 31, 2005, future minimum lease payments under non-cancelable operating leases having an initial term in excess of one year are as follows:

Years ending December 31:	
2006	\$ 375,073
2007	385,500
2008	396,240
2009	398,136
2010	63,609
Total minimum lease payments	\$1,618,558

Total minimum future rental payments have not been reduced by \$23,450 of sublease rentals expected to be received in 2006 under a non-cancelable sublease expiring in December 2006.

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5. DEPOSITS

Certificates of deposit in amounts of \$100,000 or more and their remaining maturities at December 31 are as follows:

	2005	2004
Three months or less	\$ 4,374,777	\$ 4,285,752
Over three months through six months	11,163,966	3,553,729
Over six months through twelve months	6,400,569	3,351,703
Over twelve months	15,072,324	10,745,359
Total	\$37,011,636	\$21,936,543

Interest expense on deposits, for the years ended December 31, is as follows:

	2005	2004	2003
Interest-bearing transaction	\$ 525,691	\$ 293,076	\$ 206,695
Savings and money market	575,007	244,628	195,822
Time, \$100,000 or more	980,590	531,287	444,882
Other time	1,977,231	1,369,896	1,077,643
Total interest on deposits	\$4,058,519	\$2,438,887	\$1,925,042

6. BORROWINGS

Information relating to short-term borrowings, as of December 31, 2005 and 2004, is as follows:

	Securities under agreement to repurchase			
	2005		2004	
	Amount	Rate	Amount	Rate
As of year end	\$ 916,158	3.10%	\$1,381,000	2.00%
Average for the year	\$1,392,674	2.72%	\$1,475,148	1.24%
Maximum month end balance	\$1,550,000		\$1,550,000	

	Federal funds purchased			
	2005		2004	
	Amount	Rate	Amount	Rate
As of year end	\$ 528,000	4.35%	\$ -	-
Average for the year	\$ 230,384	2.61%	\$ -	-
Maximum month end balance	\$ 528,000		\$ -	

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The Company pledges U.S. Government Treasury Securities, based upon their market values, as collateral for 100% of the principal and accrued interest of its short-term borrowings.

In the first quarter of 2004, the Company maintained commitments for a total of \$9 million of borrowing availability under unsecured federal funds lines of credit with three separate financial institutions. The Company also has approximately \$21 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of December 31, 2005. These borrowing facilities will be used, as necessary, to supplement short-term liquidity needs.

Information relating to note payable as of December 31, 2005 and 2004 is as follows:

	2005		2004	
	Amount	Rate	Amount	Rate
As of year end	\$ -	-	% \$1,250,000	5.25%
Average for the year	\$1,426,027	6.43%	\$ 129,098	4.88%
Maximum month end balance	\$2,100,000		\$1,250,000	

In 2004, note payable consisted of \$1,250,000 borrowed under a \$5 million, three-year unsecured non-revolving credit facility executed on September 28, 2004 with another financial institution. The loan paid interest at the prime rate. As of December 12, 2005, the credit facility terminated. The Company funded the repayment with proceeds from the issuance by its wholly owned subsidiary, Bay National Capital Trust I, of \$8.0 million of 30-year fixed rate trust preferred securities. See discussion below.

Information relating to subordinated debt as of December 31, 2005 and 2004 is as follows:

	2005		2004	
	Amount	Rate	Amount	Rate
As of year end	\$8,000,000	7.20%	\$ -	- %
Average for the year	\$ 438,356	7.20%	\$ -	- %
Maximum month end balance	\$8,000,000		\$ -	

On December 12, 2005, the Company participated in a private placement of \$8 million of fixed interest rate trust preferred securities (the "Trust Preferred Securities"), through a newly formed Delaware trust subsidiary, Bay National Capital Trust I (the "Trust"). The Trust was formed for the purpose of issuing the Trust Preferred Securities and all of its common securities are owned by the Company. The Company purchased the common securities from the Trust for \$248,000. In accordance with provisions of FIN46, the financial position and results of operations are not included in the Company's consolidated financial position and results of operations.

The Trust used the proceeds of the sale of the Trust Preferred Securities and common securities to purchase from the Company the aggregate principal amount of \$8,248,000 of the Company's Fixed Rate Junior Subordinated Debt Securities Due 2036 (the "Debt Securities"). Like the Trust Preferred Securities, the Debt Securities bear interest at the fixed annual rate of 7.20% until maturity. The interest expense on Trust Preferred Securities was \$28,108 in 2005. The

Debt Securities mature on February 23, 2036, but may be redeemed at the Company's option at any time on any February 23, May 23, August 23 or November 23 on or after February 23, 2011, or at any time upon certain events, such as a change in the regulatory capital treatment of Debt Securities, the Trust being deemed to be an "investment company" under the Investment Company Act of 1940, as amended, or the occurrence of certain adverse tax events. Except upon the occurrence of the events described above, which require a redemption premium for redemptions prior to February 23, 2011, the Company may redeem the Debt Securities at their aggregate principal amount, plus accrued interest, if any.

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The Parent is required to retain \$1,000,000 of the proceeds from the Debt Securities for general corporate purposes (which may include making interest payments on the Debt Securities) until the earlier of (i) the date on which the retained funds are reduced to zero, or (ii) the date on which Bay National Bank (or any successor) meets the statutory requirements to pay dividends of at least \$148,464 for each of two consecutive quarters with positive retained earnings remaining after any such dividend payment.

The Debt Securities are subordinated to the prior payment of other indebtedness of the Company that, by its terms, is not similarly subordinated. Although the Debt Securities are recorded as a liability on the Company's balance sheet, for regulatory purposes, the Debt Securities are being treated as Tier 1 or Tier 2 capital under regulatory capital guidelines issued by the Federal Reserve Board.

7. ISSUANCE OF COMMON STOCK

On October 31, 2002, Bay National Corporation commenced a private offering, to accredited investors only, of an aggregate of 550,000 shares of its common stock, which was subsequently increased to 620,690 shares of its common stock. The purchase price per share was \$7.25 for an aggregate purchase price of \$4,500,002. The private offering terminated on April 30, 2003 with all shares issued. Net proceeds after offering costs were \$4,449,261.

On August 31, 1999, the Board of Directors of the Company authorized the issuance on September 10, 1999, to each stockholder of record of the Company on August 31, 1999, a warrant to purchase one share of common stock at \$10 per share for every two shares that the stockholder purchased in the organizational offering. As a result, the Company issued warrants to purchase 56,250 shares. The warrants were issued in recognition of the financial and organizational risk undertaken by the purchasers in the organizational offering. The warrants became exercisable on April 30, 2001 and were exercisable in whole or in part until November 16, 2004. During the second half of 2004, 55,000 of these warrants were exercised resulting in the issuance of 55,000 shares of common stock and the receipt of \$550,000 of additional capital.

8. STOCK OPTIONS

The Company's 2001 Stock Option Plan ("Option Plan") provides for the granting of incentive and non-qualifying stock options to the Company's directors and to selected employees on a periodic basis at the discretion of the Board of Directors. The Option Plan authorizes the issuance of up to 200,000 shares of common stock, has a term of ten years, and is administered by the Compensation Committee of the Board of Directors. The Compensation Committee consists of at least three non-employee directors appointed by the Board of Directors. In general, the options have an exercise price, which may not be less than 100% of the fair market value on the date of the grant, must be exercised within eight years and vest over a period of six years.

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The following is a summary of changes in shares under options for the years ended December 31, 2005, 2004 and 2003:

	Number of Shares	Weighted Average Exercise Price
Balance, January 1, 2003	148,825	\$ 7.67
Granted	-	-
Cancelled	(919)	7.58
Exercised	-	-
Balance, December 31, 2003	147,906	7.67
Granted	-	-
Cancelled	(414)	7.58
Exercised	-	-
Balance, December 31, 2004	147,492	7.67
Granted	-	-
Cancelled	-	-
Exercised	(6,726)	7.58
Balance, December 31, 2005	140,766	\$ 7.67
Weighted average fair value of options granted during 2002	\$ 3.05	

The following table summarizes information about options outstanding at December 31, 2005:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$7.58	123,951	4	\$7.58	98,782	\$7.58
\$8.37	16,815	5	\$8.37	4,204	\$8.37
	140,766		\$7.67	102,986	\$7.67

9. RETIREMENT PLAN

The Company has a 401(k) profit sharing plan covering substantially all full-time employees. The plan requires the Company to match 25% of employee contributions of up to 3% of compensation as defined under the plan. The Company has also elected to make a safe harbor contribution to the plan on behalf of all eligible employees, as defined under the plan. The safe harbor contribution is equal to 3% of compensation as defined under the plan. The plan permits additional contributions at the discretion of management. Expenses under this plan totaled \$120,368, \$77,180 and \$67,388 for the years ended December 31, 2005, 2004 and 2003, respectively.

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10. INCOME TAXES

Federal and state income tax expense (benefit) consists of the following for the periods ended December 31:

	2005	2004	2003
Current federal income tax	\$ 307,000	\$ -	\$ -
Current state income tax	121,000	-	-
Deferred federal income tax expense (benefit)	(887,000)	-	-
Deferred state income tax expense (benefit)	(196,000)	-	-
Total income tax expense (benefit)	\$(655,000)	\$ -	\$ -

The following table is a summary of the tax effect of temporary differences that give rise to a significant portion of deferred tax assets:

	2005	2004
Deferred tax assets:		
Net operating loss carryforwards	\$ 62,000	\$ 955,000
Contributions	47,000	18,000
Deferred loan fees, net	105,000	-
Allowance for credit losses	979,000	525,000
Total deferred tax assets	1,193,000	1,498,000
Less valuation allowance	(62,000)	(1,381,000)
Deferred tax assets, net of valuation allowance	1,131,000	117,000
Deferred tax liabilities:		
Depreciation and amortization	(48,000)	(114,000)
Deferred loan costs, net	-	(3,000)
Net deferred tax assets (liabilities)	\$ 1,083,000	\$ -

For the year ended December 31, 2005, the Company will have a tax liability for the first time in its brief history. The Company recorded an income tax liability of \$428,000 for the year ended December 31, 2005. Taxable income for the years ended December 31, 2004 and 2003 were offset by the Company's net operating loss carryforwards available in those years. The 2005 liability was offset by the recognition of a deferred tax asset of \$1,083,000, resulting in a net tax benefit of \$655,000 for the year ended December 31, 2005. At December 31, 2004, the Company had a net operating loss carryforward of approximately \$2.5 million, which was fully utilized in 2005, except for approximately \$886,000 of state net operating loss carryforwards for the unconsolidated state tax return of Bay National Corporation.

The use of the net operating loss carryforward and the recognition of net deferred income tax assets had a positive effect on 2005 earnings. In subsequent periods, the Company will begin to record income tax expense at the statutory rate. Prior to 2005, the Company had not recorded any income tax expense or benefit. Recognizing income tax expense in future periods will have a detrimental effect on future reported earnings.

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Reported income tax benefit differed from the amounts computed by applying the U.S. federal statutory income tax rate of 34% to income before income taxes as follows:

	2005	2004	2003
Federal income tax expense computed at the statutory rate	\$ 710,372	\$ 272,770	\$ 2,578
State income tax benefit, net	(49,500)	-	-
Nondeductible expenses	13,536	9,365	11,044
Adjustment to valuation allowance	(1,329,408)	(282,135)	(13,622)
Federal income tax (benefit) expense, as reported	\$ (655,000)	\$ -	\$ -

11. RELATED PARTY TRANSACTIONS

Certain directors and executive officers have loan transactions with the Company. Such loans were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with outsiders. The following schedule summarizes changes in amounts of loans outstanding, both direct and indirect, to these persons during 2005 and 2004.

	2005	2004
Balance at beginning of period		