BAY NATIONAL CORP
Form 10QSB
May 14, 2007

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

FORM 10-QSB

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

For the quarterly period ended March 31, 2007

Commission file number: 000-51765

Bay National Corporation
(Exact name of small business issuer as specified in its charter)

Maryland	52-2176710
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2328 West Joppa Road, Lutherville, MD 21093
Address of principal executive offices

(410) 494-2580
Issuer's telephone number

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 X No

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

At May 11, 2007, the issuer had 1,937,369 shares of Common Stock outstanding.

Transitional Small Business Disclosure Format (Check One): Yes ____ No X

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

BAY NATIONAL CORPORATION

CONSOLIDATED BALANCE SHEETS
As of March 31, 2007 and December 31, 2006

ASSETS	March 31, 2007 (Unaudited)	December 31, 2006
Cash and due from banks	$ 2,159,321	$ 2,348,304
Federal funds sold and other overnight investments	18,004,874	31,549,900
Investment securities available for sale (AFS) - at fair value	697,392	697,526
Other equity securities	1,155,800	1,117,100
Loans held for sale	6,830,650	1,444,303
Loans, net of unearned fees	220,296,030	216,571,375
Total loans	227,126,680	218,015,678
Less: Allowance for credit losses	(3,202,930)	(3,175,000)
Loans, net	223,923,750	214,840,678
Premises and equipment, net	1,100,441	1,100,220
Accrued interest receivable and other assets	3,174,961	3,151,119
Total Assets	$250,216,539	$254,804,847
LIABILITIES		
Non-interest-bearing deposits	$ 31,597,066	$ 34,808,624
Interest-bearing deposits	186,665,292	189,340,328
Total deposits	218,262,358	224,148,952
Short-term borrowings	2,681,000	1,545,000
Subordinated debt	8,000,000	8,000,000
Accrued expenses and other liabilities	1,794,719	2,268,402
Total Liabilities	230,738,077	235,962,354
STOCKHOLDERS' EQUITY		
Common stock - $.01 par value, authorized: 9,000,000 shares authorized, 1,935,369 issued and outstanding as of March 31, 2007 and December 31, 2006	19,354	19,354
Additional paid in capital	17,666,178	17,649,678
Retained earnings	1,792,930	1,173,461
Total Stockholders' Equity	19,478,462	18,842,493

Total Liabilities and Stockholders' Equity	$250,216,539	$254,804,847

See accompanying notes to consolidated financial statements.

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BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
For the three-month periods ended March 31, 2007 and 2006
(Unaudited)

	Three Months Ended March 31	
	2007	2006
INTEREST INCOME:		
Interest and fees on loans	$5,084,808	$4,223,414
Interest on federal funds sold and other overnight investments	242,286	62,389
Taxable interest and dividends on investment securities	16,120	21,442
Total interest income	5,343,214	4,307,245
INTEREST EXPENSE:		
Interest on deposits	2,029,447	1,434,862
Interest on short-term borrowings	21,181	17,720
Interest on subordinated debt	148,454	149,989
Total interest expense	2,199,082	1,602,571
Net interest income	3,144,132	2,704,674
Provision for credit losses	-	-
Net interest income after provision for credit losses	3,144,132	2,704,674
NON-INTEREST INCOME:		
Service charges on deposit accounts	36,941	40,739
Gain on sale of mortgage loans	135,449	83,256
Other income	19,838	16,285
Total non-interest income	192,228	140,280
NON-INTEREST EXPENSES:		
Salaries and employee benefits	1,497,189	1,230,142
Occupancy expenses	157,214	122,408
Furniture and equipment expenses	85,237	83,674
Legal and professional fees	63,861	35,583
Data processing and other outside services	186,656	162,164
Advertising and marketing related expenses	125,582	68,634
Other expenses	179,152	142,917
Total non-interest expenses	2,294,891	1,845,522
Income before income taxes	1,041,469	999,432
Income tax expense	422,000	397,357
NET INCOME	$ 619,469	$ 602,075

Per Share Data:		
Net Income (basic)	$ .32	.31
Net Income (diluted)	$ .31	.30
Weighted Average shares outstanding (basic)	1,935,369	1,926,038
Effect of Dilution - Stock options and Restricted shares	74,728	84,804
Weighted Average shares outstanding (diluted)	2,010,097	2,010,842

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the three-months ended March 31, 2007 and 2006
(Unaudited)

	Common Stock	Additional Paid in Capital	Retained Earnings	Total Stockholders' Equity
Balances at January 1, 2007	$ 19,354	$17,649,678	$ 1,173,461	$ 18,842,493
Stock-based compensation expense	-	16,500	-	16,500
Net Income	-	-	619,469	619,469
Balances at March 31, 2007	$ 19,354	$17,666,178	$ 1,792,930	$ 19,478,462

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balances at January 1, 2006	$ 19,244	$17,451,201	$ (1,256,367)	$ 16,214,078
Issuance of Common Stock	35	26,177	-	26,212
Stock-based compensation expense	-	17,894	-	17,894
Net Income	-	-	602,075	602,075
Balances at March 31, 2006	$ 19,279	$17,495,272	$ (654,292)	$ 16,860,259

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-months ended March 31, 2007 and 2006
(Unaudited)

	2007	2006
Cash Flows From Operating Activities		
Net income	$ 619,469	$ 602,075
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	65,297	50,540
Accretion of investment discounts	(8,672)	(16,871)
Stock-based compensation expense	16,500	17,894
Gain on sale of mortgage loans	(135,449)	(83,256)
Origination of loans held for sale	(26,902,721)	(31,876,629)
Proceeds from sale of loans	21,651,823	45,649,447
Net (increase) decrease in accrued interest receivable and other assets	(23,842)	263,472
Net decrease in accrued expenses and other liabilities	(473,683)	(343,051)
Net cash (used in) provided by operating activities	(5,191,278)	14,263,621
Cash Flows From Investing Activities		
Purchases of investment securities - AFS	(691,194)	(1,927,985)
Maturities of investment securities - AFS	700,000	1,550,000
Purchase of Federal Reserve Bank stock	-	(70,850)
Purchase of Federal Home Loan Bank of Atlanta stock	(38,700)	(77,700)
Loan disbursements in excess of principal payments	(3,696,725)	(17,524,595)
Capital expenditures	(65,518)	(333,495)
Net cash used in investing activities	(3,792,137)	(18,384,625)
Cash Flows From Financing Activities		
Net (decrease) increase in deposits	(5,886,594)	7,057,222
Net increase (decrease) in short-term borrowings	1,136,000	(875,158)
Net proceeds from stock issuance	-	26,212
Net cash (used in) provided by financing activities	(4,750,594)	6,208,276
Net (decrease) increase in cash and cash equivalents	(13,734,009)	2,087,272
Cash and cash equivalents at beginning of period	33,898,204	7,493,621
Cash and cash equivalents at end of period	$ 20,164,195	$ 9,580,893
Cash paid for:		
Interest	$ 2,180,100	$ 1,465,563
Income taxes	$ 215,000	$ 431,357

See accompanying notes to consolidated financial statements.

BAY NATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three Months Ended March 31, 2007 and 2006
(Unaudited)

1. GENERAL

Organization

Bay National Corporation (the "Company") 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 (the "Bank"). On May 12, 2000, the Company purchased all the shares of common stock issued by 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.

Basis of Presentation

The accompanying consolidated financial statements include the activity of Bay National Corporation and its wholly owned subsidiary, Bay National Bank. All significant intercompany transactions and balances have been eliminated in consolidation.

The foregoing consolidated financial statements are unaudited; however, in the opinion of management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. The balances as of December 31, 2006 have been derived from audited financial statements. These consolidated financial statements should be read in conjunction with the financial statements and accompanying notes included in Bay National Corporation's 2006 Annual Report on Form 10-KSB. There have been no significant changes to the Company's Accounting Policies as disclosed in the 2006 Annual Report. The results shown in this interim report are not necessarily indicative of results to be expected for the full year 2007 or any other interim period.

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.

Reclassifications

Certain reclassifications have been made to amounts previously reported to conform to the current presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

2. REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios. Management believes, as of March 31, 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of March 31, 2007, the Bank has been categorized as "Well Capitalized" by the OCC under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios.

3. INCOME TAXES

The Company uses the liability method of accounting for income taxes as required by Statement of Financial Accounting Standards ("SFAS") No. 109, "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 basis of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse.

4. 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 earnings 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.

5. STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted SFAS No. 123(R), *Share-based Payment,* and has included the stock-based employee compensation cost in its income statements for the three-month periods ended March 31, 2007 and 2006. Amounts recognized in the financial statements with respect to stock-based compensation are as follows:

	Three Months Ended March 31	
	2007	2006
Amounts charged against income, before tax benefit	$ 16,500	$ 17,894
Amount of related income tax benefit recognized in income	$ 5,610	$ 883

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 stock options have been issued since 2002.

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

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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 equal to 100% of the fair market value of the common stock on the date of the grant, must be exercised within eight years of the date of grant and vest over a period of six years.

The unrecognized compensation cost related to unvested stock option awards was $29,432 for the quarter ended March 31, 2007 based upon a weighted average fair value of $3.05.

The following is a summary of changes in outstanding options for the three-month periods ended March 31, 2007 and 2006:

		Number of Shares		Weighted Average Exercise Price
Balance, January 1, 2006		140,766	$	7.67
Granted		-		-
Cancelled		(1,242)	$	7.58
Exercised		(3,458)	$	7.58
Balance, March 31, 2006		136,066	$	7.68
Balance, January 1, 2007		128,591	$	7.68
Granted		-		-
Cancelled		-		-
Exercised		-		-
Balance, March 31, 2007		128,591	$	7.68
Weighted average fair value of options granted during 2002	$	3.05		

The following table summarizes information about options outstanding at March 31, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
$7.58	111,776	2	$7.58	109,784	$7.58
$8.37	16,815	3	$8.37	9,157	$8.37
	128,591		$7.68	118,941	$7.64

The aggregate intrinsic value of options outstanding and exercisable as of March 31, 2007 was $1,423,078 and $1,321,337, respectively, based upon a closing price of $18.75 per share.

Restricted Stock Units

Pursuant to an employment agreement ("Agreement") dated June 1, 2006, a grant of 12,000 shares of the Company's common stock was awarded to a member of senior management. The stock grant vests as follows: 25% (3,000 shares) on the first anniversary of the Agreement; 25% (3,000 shares) on the second

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anniversary of the Agreement; 25% (3,000 shares) on the third anniversary of the Agreement; and 25% (3,000 shares) on the fourth anniversary of the Agreement. The vesting of the shares is subject to the individual being employed under this Agreement at each vesting date. Additional shares may be awarded from time to time subject to approval of the Board of Directors. The Company incurred compensation expense associated with this restricted stock of $14,212 for the three-month period ended March 31, 2007.

The unrecognized compensation cost related to unvested restricted stock awards was $180,025 for the quarter ended March 31, 2007 based upon a fair value of $18.95.

The following table summarizes the changes in outstanding shares under restricted stock grants for the three-month period ended March 31, 2007.

	Number of Shares	**Value at Issuance Date**
Unvested grants at January 1, 2007	12,000	$ 18.95
Granted	-	-
Vested	-	-
Cancelled	-	-
Unvested grants at March 31, 2007	12,000	$ 18.95

Item 2. Management's Discussion and Analysis

This discussion and analysis provides an overview of the financial condition and results of operations of Bay National Corporation (the “Parent”) and its national bank subsidiary, Bay National Bank (the “Bank”), collectively (the “Company”), as of March 31, 2007 and December 31, 2006 and for the three-month periods ended March 31, 2007 and 2006.

Overview

On May 12, 2000, the Parent became a bank holding company by purchasing all of the common stock of the Bank. The Bank opened its first office on May 12, 2000 and its second office on May 26, 2000.

The Bank serves the business communities of North Baltimore and Salisbury, Maryland.

Loan growth continued at a moderate pace for the three-month period ended March 31, 2007, while operating results improved over prior year results. Key measurements for the three-month period ended March 31, 2007 include the following:

- Total assets at March 31, 2007 decreased to $250.2 million from $254.8 million as of December 31, 2006.
- Net loans outstanding increased from $214.8 million as of December 31, 2006 to $223.9 million as of March 31, 2007.
- There was one loan, of approximately $37,000, that was considered a non-accrual loan as of March 31, 2007. There were no non-performing loans as of March 31, 2007. The Company continues to maintain appropriate reserves for credit losses.
- Deposits at March 31, 2007 decreased to $218.3 million from $224.1 million as of December 31, 2006.
- During March 2006, the Company began using brokered certificates of deposit through the Promontory Financial Network. This network provides the Company with the ability to offer its customers access to FDIC-insured deposit products in aggregate amounts exceeding current insurance limits. When the Company places funds through the certificate of deposit account registry service (CDARS) on behalf of a customer, it receives matching deposits through the network. The Company also has the ability to raise deposits directly through the network. These deposits are considered “Brokered Deposits” for bank regulatory purposes. As of March 31, 2007, the Company had approximately $5.9 million of CDARS deposits outstanding.
- Net income was $619,469 for the three-month period ended March 31, 2007, compared to $602,075 for the same period in 2006. This represents an increase of 2.9% over net income for the three-month period ended March 31, 2006.
- Net interest income, the Company’s main source of income, was $3.1 million during the three-month period ended March 31, 2007, compared to $2.7 million for the same period in 2006. This represents an increase of 16.2% for the three-month period.

· There were no charge-offs for the three-month period ended March 31, 2007. There was a full recovery of a 2006 charge-off of approximately $28,000 during the three-month period ended March 31, 2007. There were no charge-offs or recoveries for the three-month period ended March 31, 2006.

· Non-interest income increased by $51,948, or 37.0% for the three-month period ended March 31, 2007, as compared to the same period in 2006.

· Non-interest expenses increased by $449,369, or 24.3%, for the three-month period ended March 31, 2007, as compared to the same period in 2006.

· The Company's common stock closed at $18.75 on March 30, 2007, which represented a 2.1% decline from its closing price of $19.15 on March 31, 2006.

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

Results of Operations

General

The Company recorded net income of $619,469 for the three-month period ended March 31, 2007. This compares to net income of $602,075 for the same period in 2006. This is an increase of $17,394, or 2.9%, for the three-month period. The year-over-year improvement in results is due to the continued year-over-year growth of the loan portfolio, resulting in increased interest and fees on loans. The results were also aided by growth in gains recognized through the sale of residential mortgage loans.

The Bank's mortgage origination operations, located in Towson and Salisbury, Maryland, originate conventional first and second lien residential mortgage loans. The Bank sells most of its first and second lien 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 Towson 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 three-month periods ended March 31, 2007 and 2006, net gains on the sale of mortgage loans totaled $135,449 and $83,256, respectively.

Gains on the sale of mortgage loans have increased for the three-month period ended March 31, 2007 as compared to the same period in 2006 due to the Towson origination operation's portfolio of construction and rehabilitation loans that were modified to permanent financing upon completion of the project. The permanent financing is then sold in the secondary market. This portfolio did not have significant modification activity in the first quarter of 2006 due to the fact that it was still relatively new. Management believes that this type of residential lending is less sensitive to the fluctuation of interest rates than conventional mortgage loans however, demand for these types of loans is still subject to the overall strength of the housing market.

During the second quarter of 2004, the Company began purchasing 100% participations 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.

As of March 31, 2007, the Company held $3.9 million of these loans which were classified as held for sale. The Company earned $59,335 of interest on this program for the three-month period ended March 31, 2007. This compares to $137,159 for the same period in 2006. The decline in interest from this program is due to a decline in average balances from $7.3 million for the three-months ended March 31, 2006 to $3.2 million for the same period in 2007. The activity in this program declined significantly because the originating mortgage company utilized other available funding sources.

Management expects 2007 to be a challenging year for earnings and asset growth as a result of the slowing economy and the Company's need to continue to invest in personnel to support the long-term growth of the Company. Actual results will be subject to the volatility of the provision for credit losses, which is related to loan growth, the impact of declining volume in the mortgage participations purchasing program, the volatility of existing mortgage loan production, which is sensitive to economic and interest rate fluctuations and other competitive pressure that arises in a slowing economy.

Net Interest Income

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, other short-term borrowings and subordinated debt 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.

As previously stated, net interest income was $3.1 million for the three-month period ended March 31, 2007, as compared to $2.7 million for the same period in 2006. This represents an increase of 16.2% for the three-months ended March 31, 2007, as compared to the same period in 2006.

Interest income from loans and investments for the three-month period ended March 31, 2007 was $5.3 million, compared to $4.3 million for the three-month period ended March 31, 2006. The 24.1% increase for the three-month period, over the same period in 2006 was directly related to the 17.1% increase in average interest-earning assets for the three-months ended March 31, 2007 as compared to the same period in 2006. The increase in interest income was also aided by an increase in average yields due to an increase in the target federal funds rate from 4.75% as of March 28, 2006 to the current target of 5.25% which has been in effect since June 29, 2006. The yields on interest earning assets increased from 8.28% for the three-months ended March 31, 2006 to 8.77% for the three-months ended March 31, 2007.

The percentage of average interest-earning assets represented by loans was 90.0% and 94.1% for the three-month periods ended March 31, 2007 and 2006, respectively. The high percentage of loans to earning assets is consistent with management's strategy to maximize net interest income by maintaining a higher concentration of loans, which typically earn higher yields than investment securities. For the three-month period ended March 31, 2007, the average yield on the loan portfolio increased to 9.28% from 8.63% for the three-month period ended March 31, 2006. This increase is primarily due to the Federal Reserve increasing its target for the federal funds rate from 4.25% as of January 1, 2006 to 5.25% as of March 31, 2007. The growth of the construction and rehabilitation loan portfolio also contributed to improved yields since these loans often are priced higher than other loans.

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The average yield on the investment portfolio and other earning assets, such as federal funds sold, was 4.25% for the three-month period ended March 31, 2007 as compared to 2.74% for the same period in 2006. This improvement in the average yield was a direct result of the Federal Reserve actions discussed above, as well as an increase in the Company's holdings of Federal Reserve and Federal Home Loan Bank stocks, which pay dividend yields greater than those earned by the Company's cash and cash equivalents. The percentage of average interest-earning assets represented by investments was 10.0% and 5.9% for the three-month periods ended March 31, 2007 and 2006, respectively.

Interest expense from deposits and borrowings for the three-month period ended March 31, 2007 was $2.2 million, compared to $1.6 million for the comparable period in 2006. This 37.2% increase for the three-month period, is the result of a 15.4% increase in average interest-bearing liabilities for the three-month period ended March 31, 2007 as compared to the same period in 2006 as well as an increase in average rates paid. Average rates paid on these liabilities increased from 3.82% for the three-month period ended March 31, 2006 to 4.54% for the three-month period ended March 31, 2007. The increase in rates paid is directly attributable to the Federal Reserve actions discussed above.

As a result of the factors discussed above, net interest margins remained relatively flat at 5.16% for the three-month period ended March 31, 2007 as compared to 5.20% for the same period in 2006. Although market rates of interest have increased since March 31, 2006, management has been able to carefully implement deposit rate increases, which has allowed for consistent margins. Management expects that pressure to increase rates paid on deposits will increase if the target for the federal funds rate continues 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.

	Three Months Ended March 31, 2007		
	Average Balance	**Interest and fees**	**Yield/ Rate**
ASSETS			
Loans and loans held for sale	$222,318,445	$5,084,808	9.28%
Investment securities	1,813,643	16,120	3.60
Federal funds sold and other overnight investments	22,834,795	242,286	4.30
Total earning assets	246,966,883	5,343,214	8.77%
Less: Allowance for credit losses	(3,184,310)		
Cash and due from banks	2,154,643		
Premises and equipment, net	1,112,504		
Accrued interest receivable and other assets	2,774,005		
Total assets	$249,823,725		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	$ 67,345,355	588,386	3.54%
Regular savings deposits	6,191,421	33,456	2.19
Time deposits	112,854,354	1,407,605	5.06
Short-term borrowings	1,935,300	21,181	4.44
Subordinated debt	8,000,000	148,454	7.53
Total interest-bearing liabilities	196,326,430	2,199,082	4.54%
Net interest income and spread		$3,144,132	4.23%
Non-interest-bearing demand deposits	32,355,446		
Accrued expenses and other liabilities	1,822,967		
Stockholders' equity	19,318,882		
Total liabilities and stockholders' equity	$249,823,725		

Interest and fee income/earning assets	8.77%
Interest expense/earning assets	3.61
Net interest margin	5.16%
Return on Average Assets (Annualized)	1.01%
Return on Average Equity (Annualized)	13.00%
Average Equity to Average Assets	7.73%

	Three Months Ended March 31, 2006		
	Average Balance	**Interest and fees**	**Yield/ Rate**
ASSETS			
Loans and loans held for sale	$198,417,445	$4,223,414	8.63%
Investment securities	2,514,546	21,442	3.46
Federal funds sold and other overnight investments	9,896,110	62,389	2.56
Total earning assets	210,828,101	4,307,245	8.28%
Less: Allowance for credit losses	(3,000,000)		
Cash and due from banks	2,018,514		
Premises and equipment, net	996,564		
Accrued interest receivable and other assets	2,577,895		
Total assets	$213,421,074		
LIABILITIES AND STOCKHOLDERS' EQUITY			
Interest-bearing demand deposits	$ 53,327,622	393,507	2.99%
Regular savings deposits	10,331,445	16,599	.65
Time deposits	96,558,104	1,024,756	4.30
Short-term borrowings	1,875,344	17,720	3.83
Subordinated debt	8,000,000	149,989	7.60
Total interest-bearing liabilities	170,092,515	1,602,571	3.82%
Net interest income and spread		$2,704,674	4.47%
Non-interest-bearing demand deposits	25,333,352		
Accrued expenses and other liabilities	1,475,407		
Stockholders' equity	16,519,800		
Total liabilities and stockholders' equity	$213,421,074		

Interest and fee income/earning assets	8.28%
Interest expense/earning assets	3.08
Net interest margin	5.20%
Return on Average Assets (Annualized)	1.14%
Return on Average Equity (Annualized)	14.78%
Average Equity to Average Assets	7.74%

Provision for Credit Losses

There was no provision for credit losses for either of the three-month periods ended March 31, 2007 and 2006. The provision for credit losses is normally reflective of the growth in loan balances outstanding in all segments of the portfolio as well as changes in the relative level of risk in the portfolio. No provisions were necessary for the three-month periods ended March 31, 2007 and 2006 due to the fact that improvements in the relative risk mix of the portfolio offset increases in the overall level of loans outstanding. 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 three-month period ended March 31, 2007, the Company realized non-interest income of $192,228 as compared to $140,280 for the three-month period ended March 31, 2006. Gains on the sale of mortgage loans of $135,449 comprised 70.5% of the total for the three-month period ended March 31, 2007. This compares to gains on the sale of mortgage loans of $83,256, or 59.4%, of total non-interest income for the three-month period ended March 31, 2006.

The level of gains on the sale of mortgage loans increased for the three-month period ended March 31, 2007 due to the Towson origination operation’s portfolio of construction and rehabilitation loans that were modified to permanent financing upon completion of the project. This portfolio was still building during the first three months of 2006 after the Towson origination operation was added in February 2005. Although these additional capabilities have increased the level of gains on the sale of mortgage loans, while also providing interest income on construction loans, it should be noted that additional increases in interest rates or an extended slowdown in the housing market could impact the Company’s ability to generate consistent non-interest income associated with mortgage loan production.

Service charges on deposit accounts totaled $36,941 for the three-month period ended March 31, 2007, as compared to $40,739 for the same period in 2006. The decrease of 9.3% is primarily attributable to a decline in the level of overdraft fees charged on transaction accounts. This decline occurred as the average level of overdrawn balances declined by approximately 25.7% for the three-month period ended March 31, 2007 as compared to the same period in 2006. The decline is a result of the Company’s ongoing emphasis of attracting relationships that tend to maintain higher account balances.

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, risk management and employee benefit services. No assurance can be given that such fee arrangements will be obtained or maintained.

Non-Interest Expense

Non-interest expense for the three-month period ended March 31, 2007 totaled $2.3 million. This compares to non-interest expense for the comparable period in 2006 of $1.8 million. The majority of the increase of $449,369, or 24.3%, resulted from a period-over-period increase in salaries and benefits of $267,047, or 21.7%. The increases in salaries and benefits related to staffing growth, including the addition of a Senior Business Development Officer in June 2006, as well as staffing growth in residential real estate lending, commercial account portfolio managers and other operational support. These additions were made to continue to expand the

Bank's market presence, as well as to manage the growth of the loan and deposit portfolios and support increased operational volume.

Occupancy expenses increased by $34,806 for the three-months ended March 31, 2007, as compared to the same period in 2006. The 28.4% increase for the period was due to scheduled rent increases and the acquisition of new space obtained to facilitate the relocation of the Company's Towson residential lending operation during the fourth quarter of 2006.

Legal and professional fees increased $28,278, or 79.5%, for the three-months ended March 31, 2007, as compared to the same period in 2006. The increase was related to legal fees incurred in connection with the drafting of a Stock Incentive Plan, as well as increased costs associated with drafting the Annual Report and Proxy materials. There was also an increase in internal and external audit, and other accounting fees related to Company growth and implementation of provisions of the Sarbanes-Oxley Act of 2002 related to the documentation and testing of internal control over financial reporting.

Data processing and other outside services expense increased $24,492, or 15.1%, for the three-months ended March 31, 2007 as compared to the same period in 2006. The increase for the period is due to the cost of supporting a computer infrastructure at an additional location, the costs associated with enhanced security and preventive maintenance programs and an increase in outsourced data and item processing costs that are a function of the growth of the bank and the number of customer accounts.

Advertising and marketing-related expenses increased $56,948, or 83.0%, for the three-months ended March 31, 2007, as compared to the same period in 2006. The increase was related to the number of business development professionals on staff, an enhanced effort to increase the Company's name recognition in order to continue the growth of the customer base and an increase of $32,000 in charitable contributions.

The $37,798, or 16.7%, increase in all other non-interest expense items for the three-month period ended March 31, 2007, relates to a $24,000 increase in director fees as well as increases in other various costs associated with the increased size and complexity of the Company. The increase in director fees was designed to attract and retain governance professionals that can capably oversee the strategic direction of the Company.

The banking industry utilizes an "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 68.8% for the three-month period ended March 31, 2007. This compares to 64.9% for the same period in 2006. The increase in the efficiency ratio from the prior year is a result of management's decision to continue to invest in personnel to support the long-term growth of the Company.

Management will continue to focus on leveraging its cost structure to generate profitable growth. Management believes that, while continued growth of the Company's customer base will require additional staffing and space in order to generate new business, service customers and effectively manage the business, this additional growth can continue without impairing the long-term efficiency of the Company.

Income Taxes

For the three-month periods ended March 31, 2007 and 2006, the Company recorded income tax expense of $422,000 and $397,357, respectively. The increase is primarily a result of an increase in taxable income for the 2007 period.

Financial Condition

Composition of the Balance Sheet

As of March 31, 2007 total assets were $250,216,539. This represents a decrease of $4,588,308, or 1.8%, since December 31, 2006. The change in total assets includes decreases of $188,983 in cash and due from banks, $13,545,026 in Federal funds sold and other overnight investments and $134 in investment securities available for sale. These decreases were partially offset by increases of $38,700 in other equity securities, $9,083,072 in loans net of the allowance for credit losses and $24,063 in other non-earning assets.

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 that 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, during which time the secondary market investor reviews the files for completeness and accuracy. The Company earns interest on these loans at a rate indexed to the prime rate. The primary risk of 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 March 31, 2007, the Company held $3.9 million of these loans which were classified as held for sale. There were no loans outstanding under this program as of December 31, 2006. This fluctuation in balances is indicative of the mortgage company’s ability to use other funding sources as its volume fluctuates. The remaining increase in loans held for sale resulted from normal fluctuations of loan volume originated by the Company’s Towson and Salisbury mortgage operations.

As of March 31, 2007, loans, excluding loans held for sale, totaled $220,296,030. This represents an increase of $3,724,655, or 1.7%, from a balance of $216,571,375 as of December 31, 2006. All of this growth is a result of residential construction and rehabilitation lending generated by the Towson residential lending group. Excluding Towson residential construction and rehabilitation loans, outstanding loans declined by approximately $1.1 million due to significant pay downs and payoffs. A total of approximately $8.7 million in loans, that were outstanding as of December 31, 2006, were paid off during the first three months of 2007. This activity, combined with normal fluctuations in revolving credit balances and installment payments on amortizing loans, offset all of the approximately $10.5 million in new loans funded during that same period. The Company continues to seek prudent growth through the identification of new market segments, 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.

The composition of the loan portfolio as of March 31, 2007 was approximately $87.8 million of commercial loans, $3.5 million of consumer loans, and $129.0 million of real estate loans (excluding mortgage loans held for sale). The composition of the loan portfolio as of December 31, 2006 was approximately $88.5 million of commercial loans, $3.3 million of consumer loans, and $124.8 million of real estate loans (excluding mortgage loans held for sale). Mortgage loans held for sale were $6.8 million and $1.4 million as of March 31, 2007 and December 31, 2006, respectively.

Funds not extended in loans are invested in cash and due from banks and various investments, including federal funds sold and other overnight investments, U.S. Treasury securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. These investments totaled approximately $22.0 million as of March 31, 2007 compared to approximately $35.7 million as of December 31, 2006.

At March 31, 2007, the Company had federal funds sold and other overnight investments totaling $18,004,874 as compared to $31,549,900 as of December 31, 2006. This decrease is a result of management's decision to maintain margins by using available liquidity to fund loan growth and allow non-core time deposits to mature. The Company held $607,300 of Federal Reserve Bank stock as of both March 31, 2007 and December 31, 2006. The Company also held Federal Home Loan Bank of Atlanta stock of $548,500 and $509,800 as of March 31, 2007 and December 31, 2006, respectively, and United States Treasury bills with a maturity value of $700,000 as of both March 31, 2007 and December 31, 2006. The Treasury securities are used to collateralize repurchase agreements, which are classified as short-term borrowings under which $300,000 were outstanding as of December 31, 2006. There were no outstanding borrowings under repurchase agreements as of March 31, 2007. As of March 31, 2007 and December 31, 2006, approximately $307,000 and $334,000, respectively, of Treasury securities were pledged to collateralize uninsured deposits held for a municipal government. Management has made a decision to maintain an appropriate level of liquidity in the investment portfolio in order to ensure that funds are readily available to fund the growth of the loan portfolio and to meet the needs of deposit customers.

Deposits at March 31, 2007 were $218.3 million, of which approximately $10.2 million, or 4.7%, was related to one customer. Deposits at December 31, 2006 were $224.1 million, of which deposits for this same customer stood at approximately $8.2 million, or 3.7%, of total deposits. The deposits for this customer tends 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.

In the first quarter of 2006, the Company began using brokered certificates of deposit through the Promontory Financial Network. Through this deposit matching network and its certificate of deposit account registry service (CDARS), the Company has the ability to offer its customers access to FDIC-insured deposit products in aggregate amounts exceeding current insurance limits. When the Company places funds through CDARS on behalf of a customer, it receives matching deposits through the network. The Company also has the ability to raise deposits directly through the network. These deposits are also considered "Brokered Deposits" for bank regulatory purposes. As of March 31, 2007, the Company had approximately $5.9 million of CDARS deposits outstanding of which $2.8 million was placed on behalf of customers and $3.1 million was raised by the Company. As of December 31, 2006, the Company had approximately $4.6 million of CDARS deposits outstanding of which $1.6 million was placed on behalf of customers and $3.0 million was raised by the Company.

The market in which the Company operates is very competitive; therefore, 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 March 31, 2007, the Company had outstanding certificates of deposit of approximately $23.3 million that were either obtained through the listing of certificate of deposit rates on two Internet-based listing services (such deposits are sometimes referred to herein as national market certificates of deposit). The national market certificates of deposit were issued with an average yield of 5.11% and an average term of 32.4 months. Included

in the $23.3 million are national market certificates of deposit totaling $1.4 million that have been classified as "Brokered Deposits" for bank regulatory purposes. These "Brokered Deposits" were issued with an average yield of 5.55% and an average term of 21.6 months. As of December 31, 2006, the total certificates of deposit obtained through the listing of certificate of deposit rates on the Internet-based listing services were approximately $26.6 million. Included in the $26.6 million are national market certificates of deposit totaling $1.4 million that have been classified as "Brokered Deposits" for bank regulatory purposes.

Core deposits, which management categorizes as all deposits other than national market certificates of deposit, CDARS deposits and $7.2 million of the $10.2 million deposits from the large customer described above, stood at $184.5 million as of March 31, 2007, down 2.6% from $189.4 million as of December 31, 2006. The decrease in core deposits was due to careful management of interest rates during the period. The Company did not aggressively compete for new deposits since adequate liquidity was available to fund loan growth. 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.

As of March 31, 2007, short-term borrowings included borrowings of $2.7 million of borrowings under an Overnight Commercial Paper program. These borrowings are unsecured and are subordinated to all deposits.

As of December 31, 2006, short-term borrowings included $300,000 of 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 its short-term borrowings. Short-term borrowings as of December 31, 2006 also included $1.2 million of borrowings under the Overnight Commercial Paper program.

Subordinated debt consists of $8 million of fixed interest rate trust preferred securities (the "Trust Preferred Securities"), issued through a Delaware trust subsidiary, Bay National Capital Trust I (the "Trust"). The Company formed the Trust on December 12, 2005, and the Trust issued $8 million of trust preferred securities to investors at a fixed interest rate of 7.20%. The preferred securities bear a maturity date of February 23, 2036, but may be redeemed at the Company's option on any February 23, May 23, August 23 or November 23 on or after February 23, 2011, and require quarterly distributions by the trust to the holder of the trust preferred securities. The securities are subordinated to the prior payment of any other indebtedness of the Company that, by its terms, is not similarly subordinated securities. The trust preferred securities qualify as Tier 1 capital, subject to regulatory guidelines that limit the amount included to an aggregate of 25% of Tier 1 capital.

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 believes 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 those values are adjusted 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.

The allowance for credit losses as of March 31, 2007 and December 31, 2006 was $3,202,930 and $3,175,000, respectively. The amount equates to 1.41% and 1.46% of outstanding loans, including loans held for sale, as of March 31, 2007 and December 31, 2006, respectively. The decreased percentage as of March 31, 2007 was due to the decreased level of risk in the loan portfolio as of March 31, 2007 as some higher risk loans were paid off during the year. Bay National Corporation has no exposure to foreign countries or foreign borrowers.

As of March 31, 2007, the Company had one non-accrual loan with an unpaid principal balance and fees of approximately $37,000. Management believes that the allowance for credit losses is adequate for this loan. Any losses on this loan will be charged off as soon as the amount of loss is determinable.

The Company recovered $27,930 of 2006 charge-offs during the three-month period ended March 31, 2007 and there were no charge-offs or recoveries during the same period in 2006.

Management believes that the overall allowance for credit losses is adequate for each period presented.

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 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 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 March 31, 2007, the Company had $2,159,321 in cash and due from banks, $18,004,874 in federal funds sold and other overnight investments, $697,392 in three-month U.S. Treasury Securities, and $6,830,650 in loans expected to be sold within 60 days. As of December 31, 2006, the Company had $2,348,304 in cash and due from banks, $31,549,900 in federal funds sold and other overnight investments, $697,526 in three-month U.S. Treasury Securities, and $1,444,303 in loans expected to be sold within 60 days.

The decrease in the overall level of liquid assets is the result of a deliberate effort by management to tightly manage liquidity by allowing higher cost certificates of deposits to mature in order to better match liquidity with loan growth to maximize net interest margin. Growth in the Company’s loan portfolio, without corresponding growth in deposits, would reduce liquidity as would reductions in the level of customer deposits.

The Company has 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 $22 million of borrowing capacity with the Federal Home Loan Bank of Atlanta as of March 31, 2007. 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 choose 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 liquidity, capital or operations, nor is management aware of any current recommendation by regulatory authorities, which if implemented, would have a material effect on liquidity, capital or operations.

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 subject to interest rate pricing within a given time period, including both floating rate or adjustable rate instruments and instruments which are approaching maturity.

The following table sets forth the amount of the Company's interest-earning assets and interest-bearing liabilities as of March 31, 2007, which are expected to mature or reprice in each of the time periods shown:

			Maturity or repricing within			
	Amount	Percent of Total	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	$ 18,004,874	7.29%	$18,004,874	$ -	$ -	$ -
Loans held for sale	6,830,650	2.76%	6,830,650	-	-	-
Loans - Variable rate	109,873,853	44.49%	109,873,853	-	-	-
Loans - Fixed rate	110,422,177	44.71%	28,001,127	36,823,236	42,606,993	2,990,821
Other earning assets	1,853,192	0.75%	697,392	-	-	1,155,800
Total interest-earning assets	$246,984,746	100.00%	$163,407,896	$ 36,823,236	$42,606,993	$ 4,146,621
Interest-bearing liabilities						
Deposits - Variable rate	$ 73,771,906	37.38%	$73,771,906	$ -	$ -	$ -
Deposits - Fixed rate	112,893,386	57.21%	36,880,174	49,750,350	26,262,862	-
Short-term borrowings - Variable rate	2,681,000	1.36%	2,681,000	-	-	-
Subordinated debt	8,000,000	4.05%	-	-	-	8,000,000
Total interest-bearing liabilities	$197,346,292	100.00%	$113,333,080	$ 49,750,350	$26,262,862	$ 8,000,000
Periodic repricing differences						
Periodic gap			$50,074,816	$(12,927,114)	$16,344,131	$ (3,853,379)
Cumulative gap			$50,074,816	$ 37,147,702	$53,491,833	$49,638,454
Ratio of rate sensitive assets to rate sensitive liabilities			144.18%	74.02%	162.23%	51.83%

The Company has 54.5% of its interest-earning assets and 38.7% of its interest-bearing liabilities in variable rate balances. Interest-earning assets exceed interest-bearing liabilities by $49,638,454. The majority of this gap is concentrated in items maturing or repricing within one year. This gap is generally reflective of the Company’s emphasis on originating variable rate loans and short-term fixed rate loans and the demand in the market for higher yielding fixed rate deposits. This analysis indicates that the Company generally will benefit from increasing 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 evaluates 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 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.

Off-Balance Sheet Arrangements

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk. 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.

Outstanding loan commitments and lines and letters of credit as of March 31, 2007 and December 31, 2006 are as follows:

	March 31, 2007	December 31, 2006
Loan commitments	$ 31,909,082	$ 33,782,891
Unused lines of credit	71,651,288	66,660,250
Letters of credit	2,632,445	2,188,659

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 collateral requirement is evaluated on a case-by-case basis.

The decrease in the overall level of loan commitments as of March 31, 2007 as compared to December 31, 2006 is due to a decline in construction lending activity resulting from the overall slow down in real estate activity. The increase in unused lines of credit as of March 31, 2007 as compared to December 31, 2006 is reflective of the level of business development activity undertaken during the year.

Capital Resources

The Company had stockholders' equity at March 31, 2007 of $19,478,462 as compared to $18,842,493 at December 31, 2006. The increase in capital is a result of the positive operating results for the three-months ended March 31, 2007. Management believes that the Company has adequate capital to support projected asset growth over the next 12 months.

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 have paid dividends to the Company without approval from bank regulatory agencies at March 31, 2007; however, such payments are not currently planned.

Reconciliation of Non-GAAP Measures

Below is a reconciliation of total deposits to core deposits as of March 31, 2007 and December 31, 2006, respectively:

		March 31, 2007		December 31, 2006
Total deposits	$	218,262,358	$	224,148,952
National market certificates of deposit (includes CDARS deposits)		(26,518,057)		(29,586,997)
Variable balance accounts (1 customer at March 31, 2007 and December 31, 2006)		(10,222,514)		(8,197,951)
Portion of variable balance accounts considered to be core		3,000,000		3,000,000
Core deposits	$	184,521,787	$	189,364,004

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 consolidated 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.

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.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for credit losses. 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 "Allowance for Credit Losses and Credit Risk Management."

Item 3. Controls and Procedures

As of the end of the period covered by this quarterly report on Form 10-QSB, Bay National Corporation's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of Bay National Corporation's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Based upon that evaluation, Bay National Corporation's Chief Executive Officer and Chief Financial Officer concluded that Bay National Corporation's disclosure controls and procedures are effective as of March 31, 2007. Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed by Bay National Corporation in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

In addition, there were no changes in Bay National Corporation's internal control over financial reporting (as defined in Rule 13a-15 under the Exchange Act) during the quarter ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, Bay National Corporation's internal control over financial reporting.

Information Regarding Forward-Looking Statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933, as amended and Section 21E of the Exchange Act. Forward-looking statements also may be included in other statements that we make. All statements that are not descriptions of historical facts are forward-looking statements. 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.

The statements presented herein with respect to, among other things, the Company's plans, objectives, expectations and intentions, including statements regarding profitability, liquidity, allowance for loan losses, interest rate sensitivity, market risk and financial and other goals are forward looking. These statements are based on the Company's beliefs and assumptions, and on information available to it as of the date of this filing, and involve risks and uncertainties. These risks and uncertainties include, among others, those discussed in this report on Form 10-QSB; the Company's limited operating history; dependence on key personnel; risks related to the Bank's choice of loan portfolio; risks related to the Bank's lending limit; risks of a competitive market; the impact of any new or amended government regulations on operating results; and the effects of developments in technology. For a more complete discussion of these risks and uncertainties, see the discussion under the caption "Risk Factors" in Bay National Corporation's Form 10-KSB for the year ended December 31, 2006. The Company's actual results and the actual outcome of our expectations and strategies could differ materially from those anticipated or estimated 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 the Company undertakes no obligation to update the forward-looking statements to reflect factual assumptions, circumstances or events that have changed after the forward-looking statements are made.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

None

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

None

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None

Item 5. Other Information.

None

Item 6. Exhibits.

(a) Exhibits.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a) Certification of Chief Financial Officer

32 Rule 13a-14(b) Certification of Chief Executive Officer and Chief Financial Officer

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	Bay National Corporation	
Date: May 14, 2007	By:	/s/ Hugh W. Mohler Hugh W. Mohler, President (Principal Executive Officer)
Date: May 14, 2007	By:	/s/ Mark A. Semanie Mark A. Semanie, Treasurer (Principal Accounting and Financial Officer)