

BANCORP RHODE ISLAND INC
Form 10-K
March 09, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

FORM 10-K

(Annual Report Under Section 13 of the Securities Exchange Act of 1934)

For the fiscal year ended December 31, 2005

Commission File No. 001-16101

BANCORP RHODE ISLAND, INC.

(Exact Name of Registrant as Specified in Its Charter)

Rhode Island
(State or Other Jurisdiction of
Incorporation or Organization)

05-0509802
(IRS Employer
Identification No.)

ONE TURKS HEAD PLACE, PROVIDENCE, RI 02903

(Address of Principal Executive Offices)

(401) 456-5000

(Issuer's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$0.01 per share

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. . Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statement incorporated by reference in Part III of this

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Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, as defined in Section 12b-2 of the Exchange Act of 1934.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

As of June 30, 2005, the aggregate market value of the voting common equity of the Registrant held by non-affiliates of the Registrant, based on the closing price on the Nasdaq Stock Market was \$124,344,181.

As of February 28, 2006, there were 4,755,886 shares of common stock (par value \$0.01 per share) of the Registrant issued and outstanding.

Documents incorporated by reference:

Portions of Bancorp Rhode Island's Definitive Proxy Statement for the 2006 Annual Meeting of Shareholders are incorporated by reference into Parts II and III of this Form 10-K.

See pages 56-58 for the exhibit index.

Bancorp Rhode Island, Inc.

Annual Report on Form 10-K

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PART I

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

We make certain forward looking statements in this Annual Report on Form 10-K and in other documents that we incorporate by reference into this report that are based upon our current expectations and projections about current events. We intend these forward looking statements to be covered by the safe harbor provisions for forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and we are including this statement for purposes of these safe harbor provisions. You can identify these statements by reference to a future period or periods by our use of the words estimate, project, may, believe, intend, anticipate, plan, seek, expect and similar terms or variations of these terms. These forward looking statements include:

- statements of our goals, intentions and expectations;
- statements regarding our business plans and prospects and growth and operating strategies;
- statements regarding the quality of our products and our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

Actual results may differ materially from those set forth in forward looking statements as a result of these and other risks and uncertainties, including those detailed herein under Item 1A, Risk Factors, and from time to time in other filings with the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC). We have included important factors in the cautionary statements included or incorporated in this document, particularly under Item 1A, Risk Factors, that we believe could cause actual results or events to differ materially from the forward looking statements that we make. Our forward looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make. We do not assume any obligation to update any forward looking statements.

ITEM 1. BUSINESS

Introduction

Bancorp Rhode Island, Inc. (we or the Company), a Rhode Island corporation, is the holding company for Bank Rhode Island (the Bank). The Company has no significant assets other than the common stock of the Bank. For this reason, substantially all of the discussion in this document relates to the operations of the Bank and its subsidiaries.

The Bank is a commercial bank chartered as a financial institution in the State of Rhode Island and was formed in 1996 as a result of the acquisition of certain assets and liabilities divested in connection with the merger of Fleet Financial Group, Inc. and Shawmut National Corporation. Headquartered in Providence, Rhode Island, the Bank conducts business through 16 full-service branches, with 11 located in Providence County, 4 located in Kent County and 1 located in Washington County. The Bank augments its branch network through online banking services and automatic teller machines (ATMs), both owned and leased, located throughout Rhode Island.

The Bank provides a community banking alternative in the greater Providence market which is dominated by three large banking institutions, one national and two regional. Based on total deposits as of June 30, 2005 (excluding one bank that draws its deposits primarily from the internet), the Bank is the fifth largest bank in Rhode Island and the only mid-sized commercially focused bank headquartered in Providence, the State s capital. The Bank offers a wide variety of commercial real estate, business, residential and consumer loans and leases, deposit products, nondeposit investment products, cash management and online banking services, and other banking products and services, designed to meet the financial needs of individuals and small- to mid-sized businesses. As a full-service community bank, the

Bank seeks to differentiate itself from its large bank competitors through superior personal service, responsiveness and local decision-making. The Bank's deposits are insured by the FDIC, subject to regulatory limits.

One of the Bank's principal subsidiaries, BRI Investment Corp., a Rhode Island corporation wholly-owned by the Bank, engages in the maintenance and management of intangible investments and the collection and distribution of the income from such investments.

The Company's headquarters and executive management are located at One Turks Head Place, Providence, Rhode Island 02903 and its telephone number is (401) 456-5000. The Bank also maintains an internet website at <http://www.bankri.com>.

The Company makes available free of charge through its website at <http://www.bankri.com> all reports it electronically files with, or furnishes to, the SEC, including its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. These filings are also accessible on the SEC's website at <http://www.sec.gov>.

Overview

The Company, through the Bank, concentrates its business efforts in three main areas. First, the Bank emphasizes commercial lending. The high concentration of small to mid-size businesses in our predominately urban franchise makes deployment of funds in the commercial lending area practicable. Moreover, the Bank believes it can attract commercial customers from larger competitors through a higher level of service and its ability to set policies and procedures, as well as make decisions, locally. Second, the Bank has sought to grow its demand deposit, savings and other transaction-based accounts, collectively referred to as "core deposits". The Bank has stressed development of full relationships with customers, including its commercial customers, all of whom tend to be more relationship oriented than those who are seeking stand-alone or single transaction products. Third, the Bank seeks to leverage its knowledge and customer base to develop related lines of business. Thus, the Bank has grown its consumer loan portfolio, added sales of investment products and acquired an equipment leasing company in order to increase the Bank's higher-yielding assets, increase its fee income and diversify its products and services.

The past year marked a period of significant activity, change and challenge for the Company. During the second quarter of 2005, the Company consummated an offering of approximately 628,400 shares of its common stock, realizing net proceeds of approximately \$21.5 million. These offering proceeds are intended to provide the regulatory capital base required for future expansion of the Company and other general purposes. Also, the Company undertook a leverage program in 2005, in an aggregate amount of approximately \$90 million, in an effort to offset the earnings per share dilution related to the issuance of additional shares of common stock, prior to a more profitable deployment of the capital.

The Bank opened two new branches in 2005; one in Lincoln, Rhode Island and the other in East Greenwich, Rhode Island. The Bank also added two new lines of business; one, through the Company's first acquisition and the other through organic means.

In May 2005, the Company, through its newly formed subsidiary, Macrolease Corporation, purchased substantially all of the operating assets of Macrolease International Corporation, a privately held national equipment leasing company based on Long Island in Plainview, New York. The Company will use the Macrolease platform to increase its portfolio of equipment leases, but expects to generate additional income by originating equipment leases for third parties. The Company has also introduced Macrolease to the Bank's commercial customers, thereby expanding the Bank's product offerings.

Also in May 2005, the Company launched a private banking group and entered into a formal affiliation agreement with Coastline Trust Company (Coastline). Coastline is a local privately held trust

company offering investment management, custodial and estate planning and administration services. It is the Company's intention to capitalize on its high touch, high service model to attract, as new customers, more high net worth individuals, as well as to more fully service existing customers and principals of the Bank's business customers.

In December 2005, the Company announced it would defer the opening of two new branches it had planned for 2006 (one in Pawtucket and the other in Narragansett, Rhode Island) to 2007. The interest rate environment has resulted in a decline in the net interest margin over the past year. As a result, new branches have taken longer to achieve profitability. In 2006, the Company plans to invest its resources to drive same store sales.

While the Company experienced 9% growth in its commercial loan portfolio in 2005, the Company historically had achieved commercial loan growth at a double-digit pace and is directing its efforts toward restoring that level of growth. In January 2006, the Company announced it had successfully recruited two experienced business lenders from the State's leading regional bank. One lender was named to the newly created position of Director of Corporate Banking and the other now heads the Bank's business lending unit.

Additionally, the Bank experienced changes and transitions in executive management during 2005, with the addition of both new Chief Financial and Operating Officers in the second half of the year. The Bank's Treasurer, Linda Simmons, was promoted to Chief Financial Officer in July 2005. In September 2005, the Bank realigned its executive ranks with the promotion of the Bank's Executive Vice President Retail Banking, James DeRentis, to Chief Business Officer. All externally focused lines of business now report to him.

The Bank's new Chief Operating Officer, Jeffrey Angus, joined the Company in November 2005, with responsibility for operations, technology and human resources. He brings a strong information technology and management background to the Company.

Lending Activities

The Bank's business strategy has been to grow its commercial and consumer loan portfolios while allowing its residential mortgage loan portfolio to decline gradually (as a percent of total loans) as the Bank is able to replace residential mortgage loans with higher yielding commercial and consumer loans. The Bank has allocated substantial resources to its commercial and consumer lending functions to facilitate and promote such growth. From December 31, 2000, until December 31, 2005, commercial loan and lease outstandings have increased \$225.5 million, or 106%, and consumer loan outstandings have increased \$148.4 million, or 255%. Commercial loans and leases increased from 41.0% of total loans and leases at December 31, 2000, to 46.1% of total loans and leases at December 31, 2005, and consumer and other loans increased from 11.2% of total loans and leases at December 31, 2000, to 21.7% of total loans and leases at December 31, 2005. Meanwhile, residential mortgage loans decreased from 47.8% of total loans and leases at December 31, 2000, to 32.2% of total loans and leases at December 31, 2005.

The Bank offers a variety of loan facilities to serve both commercial and consumer borrowers primarily within the State of Rhode Island and nearby areas of Massachusetts. Approximately 73% of Rhode Island businesses and 79% of Rhode Island jobs are located in Providence and Kent Counties. More than 95% of Rhode Island businesses have fewer than 100 employees. The Bank believes the financing needs of these businesses generally match the Bank's lending profile and that the Bank's branches are well positioned to facilitate the generation of loans from this customer base.

The Bank's commercial lending function is organized into three groups. The commercial real estate group originates nonowner-occupied commercial real estate, multi-family residential real estate and construction loans. The business lending group originates owner-occupied commercial real estate loans,

term loans, revolving lines of credit, and the recently acquired capacity to originate equipment leases through Macrolease. The small business group originates a variety of real estate and non-real estate loans for business lending relationships of approximately \$250,000 or less.

The Bank satisfies a variety of consumer credit needs by providing home equity term loans, home equity lines of credit, direct automobile loans, savings secured loans and personal loans, in addition to residential mortgage loans.

The Bank has tiered lending authorities. Certain senior executives have lending approval authority of up to \$1.0 million. All extensions of credit of more than \$1.0 million (up to the Bank's house lending limit of \$7.0 million) per customer relationship require the approval of the Credit Committee, which consists of members of the Bank's senior management and one outside director. Exceptions to the Bank's house lending limit require the approval of a committee of the Board of Directors. Other officers have limited lending authorities that can be exercised subject to lending policy guidelines to facilitate volume production and process flow.

The Bank issues loan commitments to prospective borrowers subject to various conditions. Commitments generally are issued in conjunction with commercial loans and residential mortgage loans and typically are for periods up to 90 days. The proportion of the total value of commitments derived from any particular category of loan varies from time to time and depends upon market conditions. At December 31, 2005, the Bank had \$214.9 million of aggregate loan commitments outstanding to fund a variety of loans.

Overall, loans and leases produced total interest income of \$53.8 million, or 77.4% of total interest and dividend income, in 2005 and \$47.1 million, or 81.6%, of total interest and dividend income, during 2004.

Commercial Real Estate and Multi-Family Loans The Bank originates loans secured by mortgages on owner-occupied and nonowner-occupied commercial and multi-family residential properties. At December 31, 2005, owner-occupied commercial real estate loans totaled \$113.0 million, or 11.9% of the total loan portfolio. Many of these customers have other commercial borrowing relationships with the Bank, as the Bank finances their other business needs. Generally these customer relationships are handled in the Bank's business lending group. Nonowner-occupied commercial real estate loans totaled \$95.8 million, or 10.1% of the total loan portfolio, and multi-family residential loans totaled \$33.7 million, or 3.5% of the total loan portfolio, and are generally handled in the Bank's commercial real estate group. These real estate secured commercial loans are offered as both fixed and adjustable rate products. The Bank typically charges higher interest rates on these loans than those charged on adjustable rate loans secured by one-to four-family residential units. Additionally, the Bank may charge origination fees on these loans.

The Bank's underwriting practices for commercial real estate and multi-family residential loans are intended to assure that the property securing these loans will generate a positive cash flow after operating expenses and debt service payments. The Bank requires appraisals before making a loan and generally requires the personal guarantee of the borrower. Permanent loans on commercial real estate and multi-family properties generally are made at a loan-to-value ratio of no more than 80%.

Loans secured by nonowner-occupied commercial real estate and multi-family properties involve greater risks than owner-occupied properties because repayment generally depends on the rental income generated by the property. In addition, because the payment experience on loans secured by nonowner-occupied properties is often dependent on successful operation and management of the property, repayment of the loan is usually more subject to adverse conditions in the real estate market or the general economy than is the case with owner-occupied real estate loans. Also, the nonowner-occupied commercial

real estate and multi-family residential business is cyclical and subject to downturns, over-building and local economic conditions.

Commercial and Industrial Loans The Bank originates non-real estate commercial loans that, in most instances, are secured by equipment, accounts receivable or inventory, as well as the personal guarantees of the principal owners of the borrower. Unlike many community banks, the Bank is able to offer asset-based commercial loan facilities that monitor advances against receivables and inventories on a formula basis. A number of commercial and industrial loans are granted in conjunction with the U.S. Small Business Administration's (SBA) loan guaranty programs and include some form of SBA credit enhancement. Commercial lending activities are supported by noncredit products and services, such as letters of credit and cash management services, which are responsive to the needs of the Bank's commercial customers.

At December 31, 2005, commercial and industrial loans totaled \$73.6 million, or 7.7% of the total loan portfolio. Generally, commercial and industrial loans have relatively shorter maturities than residential and commercial real estate loans, or are at adjustable rates without interest rate caps. Unlike residential and commercial real estate loans, which generally are based on the borrower's ability to make repayment from employment and rental income and which are secured by real property whose value tends to be relatively easily ascertainable, commercial and industrial loans are typically made on the basis of the borrower's ability to make repayment from the cash flow of the business and are generally secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial and industrial loans may be significantly dependent on the success of the business itself. Further, the collateral securing the loans may be difficult to value, fluctuate in value based on the success of the business and deteriorate over time.

Leases The Bank historically has purchased equipment leases from originators outside of the Bank. The principal lessees were the U.S. Government and its agencies for the vast majority of leases. These government leases generally have maturities of five years or less and were not dependent on residual collateral values. With the addition of Macrolease in the second quarter of 2005, the Bank is now originating equipment leases for its own portfolio, as well as originating leases for third parties as a new source of noninterest income. At December 31, 2005, leases totaled \$46.1 million, or 4.8% of the total loan and lease portfolio, with \$25.8 million of government leases and \$20.3 million of Macrolease-generated leases.

Small Business Loans The Bank utilizes the term "small business loans" to describe business lending relationships of approximately \$250,000 or less which it originates through business development officers and its branch network. These loans are generally secured by the assets of the business, as well as the personal guarantees of the business principal owners. A number of these loans are granted in conjunction with the SBA's Low-Doc and Express programs and include some form of SBA credit enhancement. At December 31, 2005, small business loans totaled \$38.6 million, or 4.1% of the total loan portfolio. Generally, small business loans are granted at higher rates than commercial and industrial loans. These loans have relatively short-term maturities or are at adjustable rates without interest rate caps.

The Bank's underwriting practices for small business loans are designed to provide quick turn-around and minimize the fees and expenses to the customer. Accordingly, the Bank utilizes a credit scoring process to assist in evaluating potential borrowers. In some cases, the Bank employs traditional underwriting practices, similar to those for commercial and industrial loans, to provide a more balanced and judgmentally-based credit decision. The Bank distinguishes itself from larger financial institutions by providing personalized service through a branch manager or business development officer assigned to the customer relationships. Lending to small businesses may involve additional risks as a result of their more limited financial and personnel resources.

Construction Loans The Bank originates residential construction loans to individuals and professional builders to construct one- to four-family residential units, either as primary residences or for resale. The Bank also makes construction loans for the purpose of constructing multi-family or commercial properties. At December 31, 2005, outstanding construction loans totaled \$37.8 million, or 4.0% of the total loan portfolio. Currently, the Bank offers interest-only construction loans during the construction period.

The Bank's underwriting practices for construction loans are similar to those for commercial real estate loans, but they also are intended to assure completion of the project and take into account the feasibility of the project, among other things. As a matter of practice, the Bank generally lends an amount sufficient to pay a percentage of the property's acquisition costs and a majority of the construction costs but requires that the borrower have equity in the project. The Bank requires property appraisals and generally the personal guarantee of the borrower, as is the case with commercial real estate loans.

The risks associated with construction lending are greater than those with commercial real estate lending and multi-family lending on existing properties for a variety of reasons. The Bank seeks to minimize these risks by, among other things, often using the inspection services of a consulting engineer for commercial construction loans, advancing money during stages of completion and generally lending for construction of properties within its market area to borrowers who are experienced in the type of construction for which the loan is made, as well as by adhering to the lending standards described above. In addition, the Bank does not usually lend to fund the construction of property being built for speculative purposes.

Residential Mortgage Loans The Bank's one- to four-family residential mortgage loan portfolio consists primarily of whole loans purchased from other financial institutions. Currently, the Bank purchases fixed- and adjustable-rate (ARM) mortgage whole loans from other financial institutions both in New England and elsewhere in the country. The Bank anticipates continuing to purchase residential mortgage loans until such time as its commercial and consumer loan originations are sufficient to utilize available cash flows. With the exception of one pool of mortgages of approximately \$32 million, servicing rights related to the whole loan mortgage portfolio are retained by the mortgage servicing companies. The Bank pays a servicing fee ranging from .25% to .375% to the mortgage servicing companies for administration of the loan portfolios. As of December 31, 2005, approximately 28% of the residential mortgage loan portfolio consisted of loans secured by real estate outside of New England.

Additionally, largely as an accommodation to the Bank's customers, fixed- and variable-rate mortgages are offered throughout the Bank's branch network. The majority of these mortgages are transferred to the Bank's correspondent third parties under precommitments to fund these transactions. However, the Bank does retain a portion of these residential mortgages for its own portfolio. In 2005, fees from these loans originated for third parties increased by \$113,000, or 159%, to \$184,000, compared to \$71,000 in the prior year. Overall, the Bank anticipates that its residential mortgage loan portfolio will decline long-term as it focuses its resources on commercial and consumer lending.

At December 31, 2005, one- to four-family residential mortgage loans totaled \$306.0 million, or 32.2% of the total loan portfolio. The fixed rate portion of this portfolio totaled \$101.6 million and had original maturities of 15 to 30 years. The adjustable rate portion of this portfolio totaled \$202.2 million and generally had original maturities of 30 years. Interest rates on adjustable rate loans are set for an initial period of one, three, five, seven or ten years with annual adjustments for the remainder of the loan. These loans have periodic rate adjustment caps of primarily 2% and lifetime rate adjustment caps of either 5% or 6%. There are no prepayment penalties for the one- to four-family residential mortgage loans.

Although adjustable rate mortgage loans allow the Bank to increase the sensitivity of its assets to changes in market interest rates, the terms of such loans include limitations on upward and downward rate

adjustments. These limitations increase the likelihood of prepayments due to refinancings during periods of falling interest rates, particularly if rate adjustment caps keep the loan rate above market rates. Additionally, these limitations could keep the market value of the portfolio below market during periods of rising interest rates, particularly if rate adjustment caps keep the loan rate below market rates.

Consumer and Other Loans The Bank originates a variety of term loans and line of credit loans for consumers. At December 31, 2005, the consumer loan portfolio totaled \$206.5 million, or 21.7% of the total loan portfolio, and was comprised primarily of home equity term loans and home equity lines of credit. These loans and lines of credit are generally offered for up to 80% of the appraised value of the borrower's home, less the amount of the remaining balance of the borrower's first mortgage. The Bank also offers direct automobile loans, savings secured loans and personal loans.

Investment Activities

Investments, an important component of the Company's diversified asset structure, are a source of earnings in the form of interest and dividends, and provide a source of liquidity to meet lending demands and fluctuations in deposit flows. Overall, the portfolio, comprised primarily of overnight investments, U.S. agency securities, corporate debt securities, mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs) and Federal Home Loan Bank of Boston (FHLB) stock, represents \$412.2 million, or 28.6% of total assets, as of December 31, 2005. The vast majority of these securities are rated investment grade by at least one major rating agency.

Loans and leases generally provide a better return than investments, and accordingly, the Company seeks to emphasize their generation rather than increasing its investment portfolio. The investments are managed by the Bank's Chief Financial Officer and Treasurer, subject to the supervision and review of the Asset/Liability Committee and are made in compliance with the Investment Policy approved by the Bank's Board of Directors. Prior to 2005, the Company had retained the services of an outside investment advisory firm to provide interest-rate risk management services and to assist in the management of the investment portfolio. The Company discontinued the services of this firm effective January 1, 2005.

Overall, investments produced total interest and dividend income of \$15.7 million, or 22.6% of total interest and dividend income, in 2005 and \$10.6 million, or 18.4%, of total interest and dividend income, during 2004.

Deposits

Deposits are the principal source of funds for use in lending and for other general business purposes. The Bank attracts deposits from businesses and the general public by offering a variety of deposit products ranging in maturity from demand-type accounts to certificates of deposit (CDs). The Bank relies mainly on quality customer service and diversified products, as well as competitive pricing policies and advertising, to attract and retain deposits. The Bank emphasizes retail deposits obtained locally.

The Bank seeks to develop relationships with its customers in order to become their primary bank. In order to achieve this, the Bank has stressed growing its core deposit account base. Core deposits remained essentially consistent on a dollar amount basis compared to the prior year (down \$4.2 million, or 0.7%). However, the balance sheet mix changed from the prior year due to the growth in CD balances. Core deposits as percentage of total deposits decreased to 64.0% at December 31, 2005 from 71.8% at December 31, 2004.

As a by-product of the Bank's continuing emphasis on checking account growth, service charges on deposit accounts (which include insufficient funds (NSF) fees) have also grown over the years and represent the largest source of noninterest income for the Company. Service charges on deposit accounts showed a moderate increase of \$47,000, or 1.0%, from \$4.5 million for 2004, to \$4.6 million for 2005.

Although the Bank would prefer growth in core accounts, the trend first evidenced in late 2004 continued as customers displayed their preference for higher-yielding term deposit accounts. As a result, the Bank offered competitively priced CDs and ran special offers for certain periods during the year. CD balances grew to \$353.0 million at December 31, 2005, compared to \$248.5 million at December 31, 2004, an increase of \$104.5 million, or 42.1%.

The Bank generally charges early withdrawal penalties on its CDs in an amount equal to three months' interest on accounts with original maturities of one year or less and six months' interest on accounts with original maturities longer than one year. Interest credited to an account during any term may be withdrawn without penalty at any time during the term. Upon renewal of a CD, only interest credited during the renewal term may be withdrawn without penalty during the renewal term. The Bank's withdrawal penalties are intended to offset the potentially adverse effects of the withdrawal of funds during periods of rising interest rates.

As a general policy, the Bank systematically reviews the deposit accounts it offers to determine whether the accounts continue to meet customers' needs and the Bank's asset/liability management goals. This review is the responsibility of the Pricing Committee, which meets weekly to determine, implement and monitor pricing policies and practices consistent with the Bank's Asset and Liability Committee's strategy, as well as overall earnings and growth goals. The Pricing Committee analyzes the cost of funds and also reviews the pricing of deposit related fees and charges.

Borrowings

The Bank also derives cash flows from several sources, including loan repayments, deposit inflows and outflows, sales of investment securities and FHLB and other borrowings. Loan repayments and deposit inflows and outflows are significantly influenced by prevailing interest rates, competition and general economic conditions. Sales of investment securities are generally infrequent and nonrecurring.

The Bank utilizes borrowings on both a shorter- and longer-term basis to compensate for reductions in normal sources of funds on a daily basis. Additionally, during 2005, the Company undertook a leverage program to partially offset the dilution of earnings per share caused by the issuance of additional common stock during the second quarter of 2005. The Company concluded the leverage program in the fourth quarter of 2005. Also, in 2005, the Bank entered into wholesale repurchase agreements with financial institutions, aggregating \$20.0 million in borrowings by year-end. At December 31, 2005, total borrowings stood at \$344.8 million compared to \$271.4 million at December 31, 2004.

Nondeposit Investment Products and Services

Since January 2001, the Bank has managed a nondeposit investment program through which it makes available to its customers a variety of mutual funds, fixed- and variable-annuities, stocks, bonds and other fee-based products. These investment products are offered through an arrangement with Commonwealth Equity Services, Inc., of Waltham, Massachusetts (Commonwealth). Commissions on nondeposit investment products for the years ending December 31, 2005, 2004 and 2003 were \$849,000, \$973,000 and \$875,000, respectively.

Employees

At December 31, 2005, the Company had 251 full-time and 58 part-time employees. The Company's employees are not represented by any collective bargaining unit, and the Company believes its employee relations are good. The Company maintains a benefit program that includes health and dental insurance, life and long-term disability insurance and a 401(k) plan.

Supervision and Regulation

Overview The Company and the Bank are subject to extensive governmental regulation and supervision. Federal and state laws and regulations govern numerous matters affecting the Bank and/or the Company, including changes in the ownership or control, maintenance of adequate capital, financial condition, permissible types, amounts and terms of extensions of credit and investments, permissible non-banking activities, the level of reserves against deposits and restrictions on dividend payments. These regulations are intended primarily for the protection of depositors and customers, rather than for the benefit of shareholders. Compliance with such regulation involves significant costs to the Company and the Bank and may restrict their activities. In addition, the passage of new or amended federal and state legislation could result in additional regulation of, and restrictions on, the operations of the Company and/or the Bank. The Company cannot predict whether any legislation currently under consideration will be adopted or how such legislation or any other legislation that might be enacted in the future would affect the business of either the Company or the Bank. The following descriptions of applicable statutes and regulations are not intended to be complete descriptions of these provisions or their effects on the Company and the Bank, but are brief summaries which are qualified in their entirety by reference to such statutes and regulations.

The Company and the Bank are subject to extensive periodic reporting requirements concerning financial and other information. In addition, the Bank and the Company must file such additional reports as the regulatory and supervisory authorities may require. The Company also is subject to the reporting and other dictates of the Securities Exchange Act of 1934, as amended (the Exchange Act), and the Sarbanes-Oxley Act of 2002. Recent SEC rules have accelerated the reporting of numerous internal events and increased the Company's filing obligations and related costs.

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the BHC Act). As a bank holding company, the Company is regulated by the Board of Governors of the Federal Reserve System (the FRB), and also is subject to certain laws of the State of Rhode Island.

The Bank is a Rhode Island chartered non-member bank of the Federal Reserve System. The Bank's deposits are insured by the Bank Insurance Fund (the BIF) of the FDIC. Accordingly, the Bank is subject to the supervision and regulation of the FDIC and the Rhode Island Department of Business Regulation (the Department of Business Regulation).

Rhode Island Regulation

As a state chartered financial institution, the Bank is subject to the continued regulation and supervision and periodic examination by the Department of Business Regulation. Rhode Island law also imposes reporting requirements on the Bank. Rhode Island statutes and regulations govern among other things, investment powers, deposit activity, trust powers and borrowings. The approval of the Department of Business Regulation is required to establish, close or relocate a branch, merge with other banks, amend the Bank's Charter or By-laws and undertake certain other enumerated activities.

If it appears to the Department of Business Regulation that a Rhode Island bank has violated its charter, or any law or regulation, or is conducting its business in an unauthorized or unsafe manner, or that the bank has been notified by its federal insurer of such insurer's intent to terminate deposit insurance, the Director of the Department of Business Regulation (the Director) may, under certain circumstances, restrict the withdrawal of deposits, order any person to cease violating any Rhode Island statutes or rules and regulations or cease engaging in any unsafe, unsound or deceptive banking practice, order that capital be restored, or suspend or remove directors, committee members, officers or employees who have violated the Rhode Island banking statutes, or a rule or regulation or order thereunder, or who are reckless or incompetent in the conduct of the bank's business.

Rhode Island law also requires any person or persons desiring to acquire control, as defined in the BHC Act, of any Rhode Island financial institution to file an extensive application with the Director. The application requires detailed information concerning the Bank, the transaction and the principals involved. The Director may disapprove the acquisition if the proposed transaction would result in a monopoly, the financial stability of the institution would be jeopardized, the proposed management lacks competence, or the acquisition would not promote public convenience and advantage. The Company is also subject to the Rhode Island Business Combination Act.

In addition, whenever the Department of Business Regulation considers it advisable, the Department may conduct an examination of a Rhode Island bank holding company, such as the Company. Every Rhode Island bank holding company also must file an annual financial report with the Department of Business Regulation.

Federal Supervision: FDIC

Overview The FDIC issues rules and regulations, conducts periodic inspections, requires the filing of certain reports and generally supervises the operations of its insured state chartered banks, that, like the Bank, are not members of the Federal Reserve System. The FDIC's powers have been enhanced in the past decade by federal legislation. With the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Crime Control Act of 1990, and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), federal bank regulatory agencies, including the FDIC, were granted substantial additional enforcement powers to restrict the activities of financial institutions and to impose or seek the imposition of increased civil and/or criminal penalties upon financial institutions and the individuals who manage or control such institutions.

The Bank is subject to the FDIC regulatory capital requirements. An FDIC-insured bank also must conform to certain standards, limitations, and collateral requirements with respect to certain transactions with affiliates such as the Company. Further, an FDIC-insured bank is subject to laws and regulations that limit the amount of, and establish required approval procedures, reporting requirements and credit standards with respect to, loans and other extensions of credit to officers, directors and principal shareholders of the Company, the Bank, and any subsidiary of the Bank, and to their related interests. FDIC approval also is required prior to the Bank's redemption of any stock. The prior approval of the FDIC or, in some circumstances, another regulatory agency, is required for mergers and consolidations. In addition, notice to the FDIC is required prior to the closing of any branch office, and the approval of the FDIC is required in order to establish or relocate a branch facility.

Proceedings may be instituted against any FDIC-insured bank, or any officer or director or employee of such bank and any other institution affiliated parties who engage in unsafe and unsound practices, breaches of any fiduciary duty, or violations of applicable laws, regulations, regulatory orders and agreements. The FDIC has the authority to terminate insurance of accounts, to issue orders to cease and desist, to remove officers, directors and other institution affiliated parties, and to impose substantial civil money penalties.

Deposit Insurance The Bank's deposits are insured by the BIF of the FDIC to the legal maximum of \$100,000 for each separately insured depositor. The Federal Deposit Insurance Act, as amended (the FDI Act) provides that the FDIC shall set deposit insurance assessment rates on a semiannual basis and requires the FDIC to increase deposit insurance assessments whenever the ratio of BIF reserves to insured deposits in the BIF is less than 1.25%.

The FDIC has established a risk-based bank assessment system the rates of which are determined on the basis of a particular institution's supervisory rating and capital level. The assessment system is based upon three supervisory categories and three capital categories, resulting in risk-based premiums which range from the current 0 basis points (subject to a \$2,000 minimum annual fee) for the most highly-rated,

well capitalized banks to 27 basis points per \$100 of domestic deposits for troubled banks which are undercapitalized (as discussed below). The Bank currently pays the minimum assessment.

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines that the institution had engaged in or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by the FDIC.

Capital Adequacy FDIC-insured institutions must meet specified minimal capital requirements and are subject to varying regulatory restrictions based upon their capital levels. All banks are subject to restrictions on capital distributions (such as dividends, stock repurchases and redemptions) and payment of management fees if, after making such distributions or payment, the institution would be undercapitalized. FDIC-insured banks that have the highest regulatory rating and are not anticipating or experiencing significant growth are required to maintain a leverage capital ratio (calculated using Tier 1 capital, as defined below, to total assets) of at least 3.0%. All other banks are required to maintain a minimum leverage capital ratio of 1.0% to 2.0% above 3.0%, with a minimum of 4.0%.

In addition, the FDIC has adopted capital guidelines based upon ratios of a bank's capital to total assets adjusted for risk, which require FDIC-insured banks to maintain a total capital-to-risk weighted assets ratio (Risk-Based Capital Ratio) of at least 8.0% and a Tier 1 Risk-Based Capital Ratio of at least 4.0%. The guidelines provide a general framework for assigning assets and off-balance sheet items (such as standby letters of credit) to broad risk categories and provide procedures for the calculation of the Risk-Based Capital Ratio. Tier 1 (sometimes referred to as core) capital consists of common shareholders' equity, qualifying, non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. Supplementary or Tier 2 capital includes perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, other preferred stock, and a limited amount of loan loss reserves. Certain intangible assets are deducted in computing the Capital Ratios.

Prompt Corrective Action Provisions In order to resolve the problems of undercapitalized institutions, FDICIA established a system known as prompt corrective action . Under prompt corrective action provisions and implementing regulations, every institution is classified into one of five categories reflecting the institution's capitalization. These categories are the following: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. For an institution to be well capitalized, it must have a total Risk-Based Capital Ratio of at least 10%, a Tier 1 Risk-Based Capital Ratio of at least 6% and a Tier 1 leverage ratio of at least 5% and not be subject to any specific capital order or directive. In contrast, an institution will be deemed to be significantly undercapitalized if it has a total Risk-Based Capital Ratio that is less than 6%, or a Tier 1 Risk-Based Capital Ratio that is less than 3%, or a leverage ratio that is less than 3%, and will be deemed to be critically undercapitalized if the bank has a ratio of tangible equity to total assets that is equal to or less than 2%.

As of December 31, 2005, the Bank's Tier 1 leverage ratio was 6.67%, its total Risk-Based Capital Ratio was 10.26% and its Tier 1 Risk-Based Capital Ratio was 11.51%. Based upon the above ratios, the Bank is considered well capitalized for regulatory capital purposes.

The activities in which a depository institution may engage and the remedies available to federal regulators vary depending upon the category described above into which an institution's level of capital falls. At each successive downward capital level, institutions are subject to more restrictions on their activities. For example, only well capitalized institutions may accept brokered deposits without prior regulatory approval (brokered deposits are defined to include deposits with an interest rate which is 75 basis points above prevailing rates paid on similar deposits in an institution's normal market area).

The FDIC has broad powers to take prompt corrective action to resolve problems of insured depository institutions, depending upon a particular institution's level of capital. For example, a bank

which does not meet applicable minimum capital requirements or is deemed to be in a troubled condition may be subject to additional restrictions, including a requirement of written notice to federal regulatory authorities prior to certain proposed changes in senior management or directors of the institution. Undercapitalized, significantly undercapitalized and critically undercapitalized institutions also are subject to a number of other requirements and restrictions.

Safety and Soundness Standards The FDI Act also directs each federal banking agency to prescribe standards for safety and soundness for insured depository institutions and their holding companies relating to operations, management, asset quality, earnings and stock valuation.

Examination FDIC requires that nearly all insured depository institutions have annual, on-site regulatory examinations and annual audits by an independent public accountant. Management must prepare an annual report, attested to by the independent public accountant, confirming management's responsibility in preparing financial statements, maintaining internal controls for financial reporting and complying with safety and soundness standards. The audit process must be overseen by an independent audit committee composed of outside directors, provided that the federal banking agencies may permit the committee to include inside directors if the bank is unable to find competent outside directors, so long as outside directors comprise a majority of the committee.

Federal Supervision: FRB

The BHC Act mandates that the prior approval of the FRB must be obtained in order for the Company to engage in certain activities such as acquiring or establishing additional banks or non-banking subsidiaries or merging with other institutions.

In addition to the need for obtaining the approval of the FRB for particular kinds of transactions, a bank holding company is required by the FRB to adhere to certain capital adequacy standards. It is the position of the FRB that a bank holding company, such as the Company, should be a source of financial strength to its subsidiary banks such as the Bank. In general, the FRB has adopted substantially identical capital adequacy guidelines as the FDIC. Such standards are applicable to bank holding companies and their bank subsidiaries on a consolidated basis for holding companies, like the Company, with consolidated assets in excess of \$150 million. If a bank holding company's capital levels fall below the minimum requirements established by the capital adequacy guidelines, the holding company will be expected to develop and implement a plan, acceptable to the FRB, to achieve adequate levels of capital within a reasonable time. Until such capital levels are achieved, the holding company may be denied approval by the FRB for certain activities such as those described in the preceding paragraph. As of December 31, 2005, on a consolidated basis, the Company's Tier 1 Leverage Ratio was 8.21%, its total Risk-Based Capital Ratio was 12.62% and its Tier 1 Risk-Based Capital Ratio was 13.87%. Based upon the above ratios, the Company is considered well capitalized for regulatory capital purposes.

Restrictions on Transactions with Affiliates and Insiders

The Bank is subject to certain federal statutes limiting transactions with non-banking affiliates and insiders. Section 23A of the Federal Reserve Act limits loans or other extensions of credit to, asset purchases with and investments in affiliates of the Bank, such as the Company, to ten percent (10%) of the Bank's capital and surplus. Further, such loans and extensions of credit, as well as certain other transactions, are required to be secured in specified amounts. Section 23B of the Federal Reserve Act, among other things, requires that certain transactions between the Bank and its affiliates must be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons. In the absence of comparable transactions, any transaction between the Bank and its affiliates must be on terms and under circumstances, including credit standards that in good faith would be offered to or would apply to nonaffiliated persons.

The restrictions on loans to officers, directors, principal shareholders and their related interests (collectively referred to herein as "insiders") contained in the Federal Reserve Act and Regulation O apply to all institutions and their subsidiaries. These restrictions include limits on loans to one borrower and conditions that must be met before such loans can be made. Loans made to insiders and their related interests cannot exceed the institution's total unimpaired capital and surplus. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions. All extensions of credit by the Bank to its insiders are in compliance with these restrictions and limitations.

Loans outstanding to executive officers and directors of the Bank, including their immediate families and affiliated companies ("related parties"), aggregated \$5.6 million at December 31, 2005 and \$5.0 million at December 31, 2004. Loans to related parties are made in the ordinary course of business under normal credit terms, including interest rates and collateral, prevailing at the time of origination for comparable transactions with other persons, and do not represent more than normal credit risk.

Interstate Banking

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 facilitated the interstate expansion and consolidation of banking organizations by permitting (i) bank holding companies such as the Company, that are adequately capitalized and managed, to acquire banks located in states outside their home states regardless of whether such acquisitions are authorized under the law of the host state, (ii) the interstate merger of banks after June 1, 1997, subject to the right of individual states to opt in early or opt out of this authority prior to such date, (iii) banks to establish new branches on an interstate basis provided that such action is specifically authorized by the law of the host state, (iv) foreign banks to establish, with approval of the appropriate regulators in the United States, branches outside their home states to the same extent that national or state banks located in such state would be authorized to do so and (v) banks to receive deposits, renew time deposits, close loans and receive payments on loans and other obligations as agent for any bank or thrift affiliate, whether the affiliate is located in the same or different state. Rhode Island adopted opt in legislation, which permits full interstate banking acquisition and branching.

Gramm-Leach-Bliley Act

In late 1999, Congress enacted the Gramm-Leach-Bliley Act (the "G-L-B Act"), which repealed provisions of the 1933 Glass-Steagall Act that required separation of the commercial and investment banking industries. The G-L-B Act expands the range of non-banking activities that certain bank holding companies may engage in while preserving existing authority for bank holding companies to engage in activities that are closely related to banking. In order to engage in these new non-banking activities, a bank holding company must qualify and register with the FRB as a financial holding company by demonstrating that each of its banking subsidiaries is well capitalized and well managed and has a rating of Satisfactory or better under the Community Reinvestment Act of 1977.

Under the G-L-B Act and its implementing regulations, financial holding companies may engage in any activity that (i) is financial in nature or incidental to a financial activity under the G-L-B Act or (ii) is complementary to a financial activity and does not impose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The G-L-B Act and its accompanying regulations specify certain activities that are financial in nature such as acting as principal, agent or broker for insurance; underwriting, dealing in or making a market in securities; and providing financial and investment advice. The new financial activities authorized by the G-L-B Act may also be engaged in by a financial subsidiary of a national or state bank, except for insurance or annuity underwriting, insurance company portfolio investments, real estate investments and development and merchant banking, which must be conducted in a financial holding company. The FRB and the Secretary of the Treasury have the authority to decide whether other activities are also financial in nature or incidental thereto, taking into

account changes in technology, changes in the banking marketplace, competition for banking services and other pertinent factors. Although the Company may meet the qualifications to become a financial holding company, it has no current plans to elect such status.

The G-L-B Act also establishes a system of functional regulation, under which the federal banking agencies will regulate the banking activities of financial holding companies and banks' financial subsidiaries, the SEC will regulate their securities activities and state insurance regulators will regulate their insurance activities. In addition, the G-L-B Act provides protections against the transfer and use by financial institutions of consumers' nonpublic, personal information. The G-L-B Act contains a variety of additional provisions, which, among others, impose additional regulatory requirements on certain depository institutions and reduce certain other regulatory burdens, modify the laws governing the Community Reinvestment Act of 1977, and address a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions.

In granting other types of financial institutions more flexibility, the G-L-B Act may increase the number and type of institutions engaging in the same or similar activities as those of the Company and the Bank, thereby creating a more competitive atmosphere. However, management believes this legislation and implementing regulations have had a more substantial impact on regional and national holding companies and banks than on community-based institutions engaged principally in traditional banking activities.

Other Aspects of Federal and State Laws

Community Reinvestment Act The Community Reinvestment Act of 1977 (CRA) and the regulations issued thereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. Under CRA, banks are rated on their performance in meeting these credit needs and the rating of a bank's performance is public. In connection with the filing of an application to conduct certain transactions, the CRA performance record of the banks involved are reviewed. Under the Bank's last CRA examination, the Bank received a Satisfactory rating.

USA PATRIOT Act The USA PATRIOT Act of 2001 (the Patriot Act), designed to deny terrorists and others the ability to obtain anonymous access to the United States financial system, has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act requires financial institutions to implement additional policies and procedures with respect to, or additional measures designed to address, the following matters, among others: money laundering; suspicious activities and currency transaction reporting; and currency crimes.

Sarbanes-Oxley Act of 2002 In July 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) which imposed significant additional requirements and restrictions on publicly-held companies, such as the Company. These provisions include requirements governing the independence, composition and responsibilities of audit committees, financial disclosures and reporting and restrictions on personal loans to directors and officers. Sarbanes-Oxley, among other things, mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and speedier transaction reporting requirements for executive officers, directors and 10% shareholders. Rules promulgated by the SEC pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to enhance their independence from management. In addition, penalties for non-compliance with the Exchange Act are heightened. The Company has not experienced any significant difficulties in complying with this legislation. However, the Company has incurred, and expects to continue to incur, costs in connection with its compliance with Section 404 of Sarbanes-Oxley which requires management to undertake an assessment of the adequacy and effectiveness of the Company's internal controls over financial reporting and requires the Company's

auditors to attest to, and report on, management's assessment and the operating effectiveness of these controls.

Insurance Sales Rhode Island legislation enacted in 1996 permits financial institutions to participate in the sale of insurance products, subject to certain restrictions and license requirements. The regulatory approvals required from the Department of Business Regulation and the FDIC depend upon the form and structure used to engage in such activities.

Check 21 The Check Clearing for the 21st Century Act, or Check 21 as it is commonly known, became effective in late 2004. Check 21 facilitates check collection by creating a new negotiable instrument called a substitute check, which permits, but does not require, banks to replace original checks with substitute checks or information from the original check and process check information electronically. Banks that do use substitute checks must comply with certain notice and recredit rights. Check 21 is expected to cut the time and cost involved in physically transporting paper items and reduce float, i.e., the time between the deposit of a check in a bank and payment, especially in cases in which items were not already being delivered same-day or overnight. The Bank is currently implementing the Check 21 authority and expects to incur minimal additional costs until all banks have adopted Check 21.

Miscellaneous The Company and/or the Bank also are subject to federal and state statutory and regulatory provisions covering, among other things, reserve requirements, security procedures, currency and foreign transactions reporting, insider and affiliated party transactions, management interlocks, sales of non-deposit investment products, loan interest rate limitations, truth-in-lending, electronic funds transfers, funds availability, truth-in-savings, home mortgage disclosure and equal credit opportunity.

Effect of Governmental Policy

The Company's revenues consist of cash dividends paid to it by the Bank. Such payments are restricted pursuant to various state and federal regulatory limitations. Banking is a business that depends heavily on interest rate differentials. One of the most significant factors affecting the Bank's earnings is the difference between the interest rates paid by the Bank on its deposits and its other borrowings, on the one hand, and, on the other hand, the interest rates received by the Bank on loans extended to its customers and on securities held in the Bank's portfolio. The value and yields of its assets and the rates paid on its liabilities are sensitive to changes in prevailing market rates of interest. Thus, the earnings and growth of the Bank will be influenced by general economic conditions, the monetary and fiscal policies of the federal government, and policies of regulatory agencies, particularly the FRB, which implement national monetary policy. The nature and impact on the Bank of any future changes in such policies cannot be predicted.

ITEM 1A. RISK FACTORS

Overview

Investing in our common stock involves a degree of risk. The risks and uncertainties described below are not the only ones facing our Company. Additional risks and uncertainties may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer.

Risks Related to Our Business

Competition with other financial institutions could adversely affect our franchise growth and profitability.

We face significant competition from a variety of traditional and nontraditional financial service providers both within and outside of Rhode Island, both in making loans and generating deposits. Our most significant competition comes from one national and two large regional banking institutions that have significant market share positions in Rhode Island. These large banks have well-established, broad

distribution networks and greater financial resources than we do, which have enabled them to market their products and services extensively, offer access to a greater number of locations and products, and price competitively.

We also face competition from a number of local financial institutions with branches in Rhode Island and in nearby Massachusetts, some of which have been acquired by both local and out-of-state service providers. Additionally, we face competition from out-of-state financial institutions which have established loan production offices in our marketplace, and from non-bank competitors. Competition for deposits also comes from short-term money market funds, other corporate and government securities funds and non-bank financial institutions such as brokerage firms, insurance companies and credit unions, the latter of which have recently experienced a resurgence in this market. Many of our non-bank competitors have fewer regulatory constraints as those imposed on federally insured state chartered banks, which gives these competitors an advantage over us in providing certain services. Such competition may limit our growth and profitability in the future.

Changes in regional and national economic conditions could adversely affect our profitability.

The population in our market area is growing slowly and economic growth in the Rhode Island area has been slow to moderate over the past several years. New England, hard hit by the 2001 recession, has trailed other parts of the nation in terms of general economic growth. Additionally, Rhode Island businesses, like many companies throughout the United States, are struggling with rapidly increasing health care costs, which may adversely affect the earnings and growth potential for such companies, which may in turn negatively impact Rhode Island's ability to attract and retain businesses in the state.

Our borrowers' ability to honor their repayment commitments is generally dependent upon the level of economic activity and general health of the regional economy. Furthermore, economic conditions beyond our control, such as the strength of credit demand by customers and changes in the general levels of interest rates, may have a significant impact on our operations, including decreases in the value of collateral securing loans. Therefore, an economic recession in this market area adversely affecting growth could cause significant increases in nonperforming assets, thereby reducing operating profits or causing operating losses, impairing liquidity and eroding capital.

Fluctuations in interest rates could adversely impact our net interest margin.

Our earnings and cash flows are heavily dependent on net interest margin, which is the difference between interest income that we earn on loans and investments and the interest expense paid on deposits and other borrowings. When maturities of assets and liabilities are not balanced, a rapid increase or decrease in interest rates could have an adverse effect on our net interest margin and results of operation. Interest rates are highly sensitive to factors that are beyond our control, including general economic conditions, inflation rates, flattening of the yield curve, business activity levels, money supply and the policies of various government and regulatory authorities. For example, increases in the discount rate by the Board of Governors of the Federal Reserve System usually lead to rising interest rates, which affects interest income, interest expense and investment portfolio. In addition, governmental policies such as the creation of a tax deduction for individual retirement accounts could increase savings rates and may affect our cost of funds. The nature, timing and effect of any future changes in interest rates on us and our future results of operations are not predictable.

Change in the composition of our loan and lease portfolio may result in greater risk of losses.

At December 31, 2005, 46.1% of our loan and lease portfolio consisted of commercial real estate, business, construction loans and leases, a slight increase from 45.4% of our loan and lease portfolio at December 31, 2004. We intend to continue to emphasize the origination of these types of loans and leases.

These loans generally have greater risk of nonpayment and loss than residential mortgage loans because repayment of these types of loans often depends on the successful business operation and income stream of the borrowers. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers than do individual one-to four-family residential loans. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a single one-to four-family residential mortgage loan.

Our allowance for loan and lease losses may be insufficient to cover actual loan and lease losses.

The risk of loan and lease losses varies with, among other things, general economic conditions, the character and size of the portfolio, delinquency trends, industry loss experience, nonperforming loan trends, the creditworthiness of borrowers and, in the case of a collateralized loan, the value of the collateral. Based upon such factors, our management arrives at an appropriate allowance for loan and lease losses by maintaining a risk rating system that classifies all loans and leases into varying categories by degree of credit risk, and establishes a level of allowance associated with each category. As part of our ongoing evaluation process, including a formal quarterly analysis of allowances, we make various subjective judgments as to the appropriate level of allowance with respect to each category, judgments as to the categorization of any individual loan or lease, as well as additional subjective judgments in ascertaining the probability and extent of any potential losses. If our subjective judgments prove to be incorrect, our allowance for loan and lease losses may not cover inherent losses in our loan and lease portfolio, or if bank regulatory officials or changes in economic conditions require us to increase the allowance for loan and lease losses, earnings could be significantly and adversely affected. Material additions to our allowance would materially decrease net income. At December 31, 2005, the allowance for loan and lease losses totaled \$12.2 million, representing 1.28% of total loans.

Our growth strategy may limit increases in profitability.

We have sought to increase the size of our franchise by pursuing business development opportunities and have grown substantially since inception. To the extent additional branches are opened, through the current expansion plan or otherwise, we are likely to experience higher operating expenses relative to operating income from the new branches, which may limit increases in profitability over the course of the expansion plan. The ability to increase profitability by establishing new branches is dependent on our ability to identify advantageous branch locations and generate new deposits and loans from those locations that will create an acceptable level of net income. There can be no assurance that new and relocated branches will generate an acceptable level of net income or that we will be able to successfully establish new branch locations in the future. In addition, there can be no assurance that we will be successful in developing new business lines or that any new products or services introduced will be profitable.

Our growth is substantially dependent on our management team.

Our future success and profitability are substantially dependent upon the management and banking abilities of our senior executives, who have substantial background and experience in banking and financial services, as well as personal contacts, in the Rhode Island market and the region generally. Competition for such personnel is intense, and there is no assurance we will be successful in retaining such personnel. Changes in key personnel and their responsibilities may be disruptive to business and could have a material adverse effect on our business, financial condition and results of operations.

Our operating history is not necessarily indicative of future operating results.

The Company, as the holding company of the Bank, has no significant assets other than the common stock of the Bank. While we have operated profitably since the first full quarter of operations, future operating results may be affected by many factors, including regional economic conditions, interest rate

fluctuations and other factors that may affect banks in general, all of which factors may limit or reduce our growth and profitability. For example, in the past, we have consistently grown our core deposit base, including checking account balances. However, customers indicated a preference for higher-yielding term deposit products in 2005 and core deposits remained essentially flat. We cannot predict whether this increased demand for CDs is temporary or reflects a longer-term trend. Similarly, nonperforming asset levels and loan and lease losses have been low since inception. Industry experience suggests that this is unlikely to continue indefinitely.

Our controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures and corporate governance policies and procedures. Systems of controls are based upon certain assumptions and can only provide reasonable, not absolute, assurance that system objectives are met. Potential failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have an adverse effect on our business, results of operations and financial condition.

We face various technological risks.

We rely heavily on communication and information systems to conduct business. Potential failures, interruptions or breaches in system security could result in disruptions or failures in our key systems, such as general ledger, deposit or loan systems. We have developed policies and procedures aimed at preventing and limiting the effect of failure, interruption or security breaches of information systems; however, there cannot be assurance that these incidences will not occur, or if they do occur, that they will be appropriately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in the loss of business, subject us to increased regulatory scrutiny or subject us to civil litigation and possible financial liability, any of which could have an adverse effect on our results of operation and financial condition.

We encounter technological change continually.

The financial services industry continually undergoes technological change. Effective use of technology increases efficiency and enables banks and financial services institutions to better serve customers and reduce costs. Our future success depends, in part, upon our ability to meet the needs of customers by effectively using technology to provide the products and services that satisfy customer demands, as well as create operational efficiencies. Additionally, many of our competitors have greater resources to invest in technological improvements. Inability to keep pace with technological change affecting the financial services industry could have an adverse impact on our business and as a result, our financial condition and results of operation.

Extensive government regulation and supervision have a significant impact on our operations.

We operate in a highly regulated industry and are subject to examination, supervision and comprehensive regulation by various regulatory agencies. These regulations are intended primarily for the protection of depositors and customers, rather than for the benefit of investors. Our compliance with these regulations is costly and restricts certain activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to capitalization guidelines established by regulators, which require maintenance of adequate capital to support growth. Furthermore, the addition of new branches requires the approval of the FDIC as well as state banking authorities in Rhode Island.

The laws and regulations applicable to the banking industry could change at any time. There is no way to predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, the cost of compliance with new laws and regulations applicable to the banking industry could adversely affect operations and profitability.

Risks Related to the Company's Common Stock

Our common stock has limited liquidity.

Even though the our common stock is currently traded on the Nasdaq Stock Market's National Market System, it has less liquidity than the average stock quoted on a national securities exchange. Because of this limited liquidity, it may be more difficult for investors to sell a substantial number of shares and any such sales may adversely affect the stock price.

We cannot predict the effect, if any, that future equity offerings, issuance of common stock in acquisition transactions, or the availability of shares of common stock for sale in the market, will have on the market price of our common stock. We cannot give assurance that sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of our common stock to decline or impair future ability to raise capital through sales of common stock.

Fluctuations in the price of our stock could adversely impact your investment.

The market price of our common stock may be subject to significant fluctuations in response to variations in the quarterly operating results, changes in management, announcements of new products or services by us or competitors, legislative or regulatory changes, general trends in the industry and other events or factors unrelated to our performance. The stock market has experienced price and volume fluctuations which have affected the market price of the common stock of many companies for reasons frequently unrelated to the operating performance of these companies, thereby adversely affecting the market price of these companies' common stock. Accordingly, there can be no assurance that the market price of our common stock will not decline.

There are limitations on our ability to pay dividends.

Our ability to pay dividends is subject to the financial condition of the Bank, as well as other business considerations. Payment of dividends by the Company is also restricted by statutory limitations. These limitations could have the effect of reducing the amount of dividends we can declare.

Shareholders may experience dilution if we issue additional stock in the future.

If our Board of Directors should determine in the future that there is a need to obtain additional capital through the issuance of additional shares of our common stock or securities convertible into shares of common stock, such issuances could result in dilution to shareholders. Similarly, if the Board of Directors decides to grant additional stock options for the purchase of shares of common stock, the addition of such stock options may expose shareholders to dilution.

Certain Anti-Takeover measures affect the ability of shareholders to effect takeover transactions.

We are subject to the Rhode Island Business Combination Act which, subject to certain exceptions, prohibits business combinations involving certain shareholders of publicly held corporations for a period of five years after such shareholders acquire 10% or more of the outstanding voting stock of the corporation. In addition, our Articles of Incorporation and By-laws, among other things, provide that, in addition to any

vote required by law, the affirmative vote of two-thirds of the holders of our voting stock, voting as a single class, is required for approval of all business combinations.

Our Board of Directors also has the authority, without further action by shareholders, to issue additional preferred stock in one or more series and to fix by resolution, the rights, preferences and privileges of such series to the extent permitted by law. Our Board could designate certain rights and privileges for such preferred stock which would discourage unsolicited tender offers or takeover proposals or have anti-takeover effects. Our Articles also provide for three classes of directors to be elected for staggered three year terms, which make it more difficult to change the composition of our Board. All of these provisions may make it more difficult to effect a takeover transaction.

Directors and executive officers own a significant portion of our common stock.

Our directors and executive officers, as a group, beneficially owned approximately 18.2% of our outstanding common stock as of December 31, 2005. As a result of their ownership, the directors and executive officers would have the ability, if they vote their shares in a like manner, to significantly influence the outcome of all matters submitted to shareholders for approval, including the election of directors.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no written comments received from the SEC staff 180 days or more before the end of the fiscal year relating to the Company's periodic or current reports under the Exchange Act.

ITEM 2. PROPERTIES

The Bank presently has a network of 16 branch offices located in Providence, Kent and Washington Counties. Seven of these branch office facilities are owned and nine are leased. Facilities are generally leased for a period of one to ten years with renewal options. The termination of any short-term lease would not have a material adverse effect on the operations of the Bank. The Company's offices are in good physical condition and are considered appropriate to meet the banking needs of the Bank's customers.

The following are the locations of the Bank's offices:

Location	Size (Square feet)	Year Opened or Acquired	Owned or Leased	Lease Expiration Date
Branch offices:				
1047 Park Avenue, Cranston, RI.	4,700	1996	Owned	N.A.
383 Atwood Avenue, Cranston, RI.	4,700	1996	Owned	N.A.
2104 Plainfield Pike, Cranston, RI.	700	2002	Owned	N.A.
1269 South County Trail, East Greenwich, RI.	2,600	2005	Leased	5/31/25
999 South Broadway, East Providence, RI.	3,200	1996	Leased	11/30/12
195 Taunton Avenue, East Providence, RI.	3,100	1996	Leased	2/28/08
1440 Hartford Avenue, Johnston, RI.	4,700	1996	Land Leased	12/31/07
625 G. Washington Highway, Lincoln, RI.	1,000	2005	Leased	12/31/12
Ten Rod Road, North Kingstown, RI.	4,000	2004	Land Leased	6/30/19
One Turks Head Place, Providence, RI.	5,000	1996	Leased	4/30/09
165 Pitman Street, Providence, RI.	3,300	1998	Leased	10/18/08
445 Putnam Pike, Smithfield, RI.	3,500	1996	Leased	7/31/09
1062 Centerville Road, Warwick, RI.	2,600	1996	Owned	N.A.
1300 Warwick Avenue, Warwick, RI.	4,200	1996	Leased	6/30/09
2975 West Shore Road, Warwick, RI.	3,500	2000	Leased	3/31/10
1175 Cumberland Hill Road, Woonsocket, RI.	3,300	1998	Owned	N.A.
Administrative and operational offices:				
625 G. Washington Highway, Lincoln, RI.	23,600	2003	Leased	12/31/12
One Turks Head Place, Providence, RI.	20,600	1999	Leased	6/30/09
One Ames Court, Plainview, NY	4,400	2005	Leased	1/31/08
Planned branch offices:				
90 Point Judith Road, Narragansett, RI	(A)	N.A.	Leased	6/30/25
499 Smithfield Avenue, Pawtucket, RI.	(A)	N.A.	Leased	7/31/20

(A) Facility currently under construction or in planning.

ITEM 3. LEGAL PROCEEDINGS

The Company is involved only in routine litigation incidental to the business of banking, none of which the Company's management expects to have a material adverse effect on the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders in the fourth quarter of 2005.

PART II**ITEM 5. MARKET FOR THE COMPANY'S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the Nasdaq Stock Market® under the symbol BARI. The following table sets forth certain information regarding our common stock for the periods indicated.

	Stock Price High	Low	Dividend Paid
2004:			
First Quarter	\$ 33.70	\$ 31.46	\$ 0.14
Second Quarter	35.97	32.45	0.14
Third Quarter	36.65	34.00	0.15
Fourth Quarter	40.71	35.20	0.15
2005:			
First Quarter	\$ 40.00	\$ 35.96	\$ 0.15
Second Quarter	38.07	35.39	0.15
Third Quarter	37.45	35.11	0.15
Fourth Quarter	36.55	33.29	0.15

As of February 28, 2006, there were approximately 1,500 holders of record of our common stock.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following table represents selected consolidated financial data as of and for the years ended December 31, 2005, 2004, 2003, 2002 and 2001. The selected consolidated financial data is derived from the Company's Consolidated Financial Statements, which have been audited by KPMG LLP. The selected consolidated financial data set forth below does not purport to be complete and should be read in conjunction with, and are qualified in their entirety by, the more detailed information, including the Consolidated Financial Statements and related Notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, appearing elsewhere herein.

	As of and for the year ended December 31,					
	2005	2004	2003	2002(a)	2001	
	(Dollars in thousands, except Per Share Data)					
Statements of operations data:						
Interest income	\$ 69,520	\$ 57,719	\$ 51,773	\$ 53,507	\$ 55,903	
Interest expense	26,619	19,625	19,453	22,180	26,537	
Net interest income	42,901	38,094	32,320	31,327	29,366	
Provision for loan and lease losses	1,474	900	1,600	1,875	1,669	
Noninterest income	9,274	8,581	8,830	7,083	5,231	
Noninterest expense	36,292	32,865	28,790	25,024	23,196	
Income before taxes	14,409	12,910	10,760	11,511	9,732	
Income taxes	4,840	4,296	3,546	3,849	3,417	
Net income	\$ 9,569	\$ 8,614	\$ 7,214	\$ 7,662	\$ 6,315	
Per share data:						
Basic earnings per common share	\$ 2.14	\$ 2.17	\$ 1.89	\$ 2.04	\$ 1.69	
Diluted earnings per common share	\$ 2.04	\$ 2.04	\$ 1.77	\$ 1.92	\$ 1.62	
Dividends per common share	\$ 0.60	\$ 0.58	\$ 0.56	\$ 0.53	\$ 0.48	
Dividend pay-out ratio	29.4	% 28.4	% 31.6	% 27.6	% 29.6	
Book value per common share	22.21	19.68	18.53	17.59	15.74	
Tangible book value per common share	\$ 19.83	\$ 16.99	\$ 15.76	\$ 14.73	\$ 12.88	
Average common shares outstanding Basic	4,478,081	3,975,413	3,819,232	3,758,214	3,730,910	
Average common shares outstanding Diluted	4,697,134	4,222,856	4,085,878	3,996,670	3,900,028	
Balance sheet data:						
Total assets	\$ 1,442,279	\$ 1,239,069	\$ 1,093,971	\$ 1,012,877	\$ 862,250	
Investment securities	150,959	104,600	98,595	101,329	49,453	
Mortgage-backed securities	234,858	159,946	106,618	156,114	150,650	
Total loans and leases receivable	950,806	886,301	814,282	670,658	610,964	
Allowance for loan and lease losses	12,168	11,906	11,078	10,096	8,524	
Goodwill, net	11,234	10,766	10,766	10,766	10,766	
Deposits	980,969	880,674	811,283	761,911	670,413	
Borrowings	344,769	271,386	203,622	179,305	129,398	
Common shareholders equity	104,832	78,923	72,107	66,427	59,097	
Total shareholders equity	104,832	78,923	72,107	66,427	59,097	
Average balance sheet data:						
Total assets	\$ 1,347,132	\$ 1,168,036	\$ 1,046,741	\$ 947,205	\$ 818,905	
Investment securities	131,711	102,827	91,153	71,481	49,881	
Mortgage-backed securities	209,004	132,946	123,524	177,753	130,342	
Total loans and leases receivable	916,273	848,550	747,174	622,545	584,400	
Allowance for loan and lease losses	11,938	11,490	10,739	9,375	8,056	
Goodwill, net	11,067	10,766	10,766	10,766	11,373	
Deposits	928,374	858,739	779,540	706,338	644,795	
Borrowings	306,344	227,365	192,068	174,668	115,677	
Common shareholders equity	95,922	74,704	69,010	61,922	56,101	
Total shareholders equity	95,922	74,704	69,010	61,922	56,101	
Operating ratios:						
Interest rate spread	2.92	% 3.07	% 2.91	% 3.04	% 3.12	%
Net interest margin	3.35	% 3.44	% 3.28	% 3.48	% 3.75	%
Efficiency ratio (b)	69.56	% 70.41	% 69.96	% 65.15	% 67.05	%
Return on average assets (c)	0.71	% 0.74	% 0.69	% 0.81	% 0.77	%
Return on average equity (c)	9.98	% 11.53	% 10.45	% 12.37	% 11.26	%

	As of and for the year ended December 31,									
	2005	2004	2003	2002(a)	2001					
	(Dollars in thousands, except Per Share Data)									
Asset quality ratios:										
Nonperforming loans to total loans	0.04	%	0.08	%	0.30	%	0.11	%	0.12	%
Nonperforming assets to total assets	0.03	%	0.06	%	0.23	%	0.08	%	0.12	%
Allowance for loan and lease losses to nonperforming loans	2,932.05	%	1,624.28	%	449.96	%	1,371.74	%	1,132.01	%
Allowance for loan and lease losses to total loans	1.28	%	1.34	%	1.36	%	1.51	%	1.40	%
Net loans charged-off to average loans outstanding	0.13	%	0.01	%	0.08	%	0.05	%	0.08	%
Capital ratios:										
Average shareholders' equity to average total assets	7.11	%	6.40	%	6.59	%	6.54	%	6.85	%
Tier I leverage ratio	8.21	%	7.06	%	6.76	%	6.19	%	5.93	%
Tier I risk-based capital ratio	12.62	%	10.01	%	9.71	%	9.63	%	9.86	%
Total risk-based capital ratio	13.87	%	11.26	%	10.92	%	10.88	%	11.10	%

(a) Earnings for 2002 and subsequent years were positively impacted by the Company's adoption of Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets* and SFAS 147, *Acquisitions of Certain Financial Institutions*. These Statements required the Company to cease amortizing its goodwill and begin reviewing it at least annually for impairment. In prior years, the amount of this amortization was \$1.2 million annually. Also see discussion under *Recent Accounting Developments*.

(b) Calculated by dividing total noninterest expenses by net interest income plus noninterest income.

(c) Excludes cumulative effect of change in accounting principle, net of taxes.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

Bancorp Rhode Island, Inc. (the *Company*), a Rhode Island corporation, is the holding company for Bank Rhode Island (the *Bank*). The Company has no significant assets other than the common stock of the Bank. For this reason, substantially all of the discussion in this document relates to the operations of the Bank and its subsidiaries.

The Bank is a commercial bank chartered as a financial institution in the State of Rhode Island. The Bank pursues a community banking mission and is principally engaged in providing banking products and services to businesses and individuals in Rhode Island and nearby areas of Massachusetts. The Bank is subject to competition from a variety of traditional and nontraditional financial service providers both within and outside of Rhode Island. The Bank offers a wide variety of commercial real estate, business, residential and consumer loans and leases, deposit products, nondeposit investment products, cash management and other banking products and services designed to meet the financial needs of individuals and small- to mid-sized businesses. The Bank also offers both commercial and consumer on-line banking products and maintains a web site at <http://www.bankri.com>. The Company and Bank are subject to the regulations of certain federal and state agencies and undergo periodic examinations by those regulatory authorities. The Bank's deposits are insured by the FDIC, subject to regulatory limits. The Bank is also a member of the FHLB.

Overview

The past year marked a period of significant activity, change, and challenge for the Company. The Company consummated a capital offering, acquired an equipment leasing subsidiary (*Macrolease*), started a private banking group and opened two new branches. In addition, there were changes to the Company's executive management team. For a fuller narrative commentary on these matters, refer to Item 1, *Business*.

The primary drivers of the Company's operating income are net interest income, which is strongly affected by the net interest margin, and the quality of the Company's assets.

The Company's net interest income is the difference between its interest income and its cost of funds. Interest income depends on the amount of interest-earning assets outstanding during the year and the interest rates earned thereon. Cost of funds is a function of the average amount of deposits and borrowed money outstanding during the year and the interest rates paid thereon. Because the Company's assets are not identical in duration and in repricing dates to its liabilities, the spread between the two is vulnerable to changes in market interest rates as well as the overall shape of the yield curve. These vulnerabilities are inherent to the business of banking and are commonly referred to as interest rate risk. How to measure interest rate risk and, once measured, how much risk to take are based on numerous assumptions and other subjective judgments. See discussion under *Asset and Liability Management*.

The quality of the Company's assets also influences its earnings. Loans and leases that are not being paid on a timely basis and exhibit other weaknesses can result in the loss of principal and/or loss of interest income. Additionally, the Company must make timely provisions to its allowance for loan and lease losses as a result of its estimates as to potential future losses; these additions, which are charged against earnings, are necessarily greater when greater potential losses are expected. Finally, the Company will incur expenses as a result of resolving troubled assets. All of these form the credit risk that the Company takes on in the ordinary course of its business and is further discussed under *Financial Condition Asset Quality*.

The Company's business strategy has been to concentrate its asset generation efforts on commercial and consumer loans and its deposit generation efforts on checking and savings accounts. These deposit accounts are commonly referred to as core deposit accounts. This strategy is based on the Company's belief that it can distinguish itself from its larger competitors, and indeed attract customers from them, through a higher level of service and through its ability to set policies and procedures, as well as make decisions, locally. The loan and deposit products referenced also tend to be geared more toward customers who are relationship oriented than those who are seeking stand-alone or single transaction products. The Company believes that its service-oriented approach enables it to compete successfully for relationship-oriented customers. Additionally, the Company is predominantly an urban franchise with a high concentration of businesses making deployment of funds in the commercial lending area practicable. Commercial loans are attractive, among other reasons, because of their higher yields. Similarly, core deposits are attractive because of their generally lower interest cost and potential for fee income.

In recent years, the Company also has sought to leverage business opportunities presented by its customer base, franchise footprint and resources. This year, the Bank formed a private banking division and completed its first acquisition with the acquiring of an equipment leasing company located in Long Island, New York (Macrolease). The Bank will use the Macrolease platform to increase its portfolio of equipment leases, but expects to generate additional income by also originating equipment leases for third parties. The Company also has introduced Macrolease to the Bank's commercial customers, thereby expanding the Bank's product offerings.

The deposit market in Rhode Island is highly concentrated. The State's three largest banks have an aggregate market share of 85% (based upon June 2005 FDIC statistics, excluding one bank that draws its deposits primarily from the internet) in Providence and Kent Counties, the Bank's primary marketplace. Competition for deposits has intensified during the past few years. Institutions in the market have increased their advertising and promotional product offerings, spurred on by the various new entrants into the market.

In 2005, approximately 82.2% of the Company's total revenues (defined as net interest income plus noninterest income) are derived from its level of net interest income. The Company continued efforts to diversify its sources of revenue, with emphasis on expanding sources of noninterest income (primarily fees

and charges for products and services the Bank offers). The Company has increased its percentage of noninterest income to total revenue from 12.0% in 2000, to 17.8% in 2005, as the Company experienced growth in the area of commissions on loans and leases originated for third parties and loan related fees.

During 2005, lower-yielding liquid savings accounts such as money market and NOW accounts declined; however core deposits remained flat due to moderate increases in demand deposit accounts. The Bank's deposit growth was centered in higher-yielding CD's. This shift in deposit mix has increased the Bank's cost of funds. The combination of the flattening yield curve and cost of funds increase resulted in significant pressure on the Bank's net interest margin, which has negatively affected net interest income. The Bank experienced an overall decrease in net interest margin, as 2005's net interest margin of 3.35% was 9 basis points lower than 2004's net interest margin of 3.44%.

The Company anticipates that 2006, and in particular, the flattening yield curve and shift in the deposit mix, will pose significant challenges to the Company. The future operating results of the Company will again depend on the ability to maintain and expand net interest margin, while minimizing exposure to credit risk, along with increasing sources of noninterest income, while controlling the growth of noninterest or operating expenses.

Critical Accounting Policies

Accounting policies involving significant judgments and assumptions by management, which have, or could have, a material impact on the carrying value of certain assets or net income, are considered critical accounting policies. The Company considers the following to be its critical accounting policies: allowance for loan and lease losses and review of goodwill for impairment. There have been no significant changes in the methods or assumptions used in accounting policies that require material estimates or assumptions.

Allowance for loan and lease losses

Arriving at an appropriate level of allowance for loan and lease losses necessarily involves a significant degree of judgment. First and foremost in arriving at an appropriate allowance is the creation and maintenance of a risk rating system that accurately classifies all loans and leases into varying categories by degree of credit risk. Such a system also establishes a level of allowance associated with each category of loans and requires early identification and reclassification of deteriorating credits. Besides numerous subjective judgments as to the number of categories, appropriate level of allowance with respect to each category and judgments as to categorization of any individual loan or lease, additional subjective judgments are involved when ascertaining the probability as well as the extent of any potential losses. The Company's ongoing evaluation process includes a formal analysis of the allowance each quarter, which considers, among other factors, the character and size of the loan and lease portfolio, business and economic conditions, loan growth, delinquency trends, nonperforming loan trends, charge-off experience and other asset quality factors. These factors are based on observable information, as well as subjective assessment and interpretation. Nonperforming commercial, commercial real estate and small business loans in excess of a specified dollar amount are deemed to be impaired. The estimated reserves necessary for each of these credits is determined by reviewing the fair value of the collateral, the present value of expected future cash flows, and where available, the observable market price of the loans. Provisions for losses on the remaining commercial, commercial real estate, small business, residential mortgage and consumer loans and leases are based on pools of similar loans or leases using a combination of payment status, historical loss experience, industry loss experience, market economic factors, delinquency rates and qualitative adjustments. Management uses available information to establish the allowance for loan and lease losses at the level it believes is appropriate. However, future additions to the allowance may be necessary based on changes in estimates or assumptions resulting from changes in economic conditions and other factors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan and lease losses. Such agencies

may require the Company to recognize adjustments to the allowance based on their judgments about information available to them at the time of their examination.

Review of goodwill for impairment

In March 1996, the Bank acquired certain assets and assumed certain liabilities from Fleet Financial Group, Inc. and related entities. This acquisition was accounted for utilizing the purchase method of accounting and generated \$17.5 million of goodwill. This goodwill was amortized in the years prior to 2002, resulting in a net balance of \$10.8 million on the Company's balance sheet as of December 31, 2001. Effective January 1, 2002, in accordance with Statement of Financial Accounting Standards (SFAS) 142 *Goodwill and Other Intangible Assets* and SFAS 147 *Acquisitions of Certain Financial Institutions* , the Company ceased amortizing this goodwill and began to review it at least annually for impairment.

On May 1, 2005, the Bank acquired certain operating assets from Macrolease International Corporation. This acquisition was accounted for utilizing the purchase method of accounting and generated \$468,000 of goodwill.

Goodwill is evaluated for impairment using market value comparisons for similar institutions, such as price to earnings multiples, price to deposit multiples and price to equity multiples. This valuation technique utilizes verifiable market multiples, as well as subjective assessment and interpretation. The application of different market multiples, or changes in judgment as to which market transactions are reflective of the Company's specific characteristics, could affect the conclusions reached regarding possible impairment. In the event that the Company were to determine that its goodwill were impaired, the recognition of an impairment charge could have an adverse impact on its results of operations in the period that the impairment occurred or on its financial position.

Results of Operations

Net Interest Income

Net interest income for 2005 was \$42.9 million, compared to \$38.1 million for 2004 and \$32.3 million for 2003. The net interest margin decreased in 2005 to 3.35%, compared to 3.44% in 2004. In 2003, the net interest margin was 3.28%. The increase in net interest income of \$4.8 million, or 12.6%, during 2005 was primarily attributable to the continued growth of the Company. Average earning assets increased \$172.4 million, or 15.6%, and average interest-bearing liabilities increased \$143.4 million, or 15.6%, during 2005, compared to 2004.

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Average Balances, Yields and Costs

The following table sets forth certain information relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the years indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities. Average balances are derived from daily balances and include nonperforming loans.

	Year ended December 31, 2005			2004			2003		
	Average balance	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield
	(Dollars in thousands)								
Assets									
Earning assets:									
Overnight investments	\$ 8,015	\$ 201	2.51 %	\$ 12,286	\$ 138	1.12 %	\$ 15,993	\$ 170	1.06 %
Investment securities	131,711	5,537	4.20 %	102,827	4,452	4.33 %	91,153	3,999	4.39 %
Mortgage-backed securities	209,004	9,313	4.46 %	132,946	5,709	4.29 %	123,524	4,886	3.96 %
Stock in the FHLB	14,842	647	4.36 %	10,811	308	2.85 %	8,633	262	3.03 %
Loans receivable:									
Commercial loans and leases	421,429	28,015	6.65 %	369,263	23,092	6.25 %	309,105	19,494	6.31 %
Residential mortgage loans	307,659	15,670	5.09 %	337,825	17,087	5.06 %	334,754	17,677	5.28 %
Consumer and other loans	187,185	10,137	5.42 %	141,462	6,933	4.90 %	103,315	5,285	5.12 %
Total earning assets	1,279,845	69,520	5.43 %	1,107,420	57,719	5.21 %	986,477	51,773	5.25 %
Cash and due from banks	25,218			23,170			24,902		
Allowance for loan and lease losses	(11,938)			(11,490)			(10,739)		
Premises and equipment	13,765			12,709			11,732		
Goodwill, net	11,067			10,766			10,766		
Accrued interest receivable	5,174			4,584			4,554		
Bank-owned life insurance	18,452			16,026			15,175		
Prepaid expenses and other assets	5,549			4,851			3,874		
Total assets	\$ 1,347,132			\$ 1,168,036			\$ 1,046,741		
Liabilities and Shareholders Equity									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 94,296	590	0.63 %	\$ 123,064	1,172	0.95 %	\$ 114,767	1,363	1.19 %
Money market accounts	17,577	235	1.34 %	16,315	213	1.31 %	11,587	121	1.04 %
Savings accounts	337,756	4,734	1.40 %	325,019	3,899	1.20 %	301,667	4,043	1.34 %
Certificate of deposit accounts	304,572	8,962	2.94 %	225,381	5,638	2.50 %	210,081	5,916	2.82 %
Overnight and short-term borrowings	23,019	652	2.83 %	16,643	157	0.94 %	18,324	140	0.76 %
Wholesale repurchase agreements	9,417	276	2.93 %			0.00 %			0.00 %
FHLB borrowings	255,350	9,898	3.88 %	193,234	7,505	3.88 %	163,155	7,185	4.40 %
Subordinated deferrable interest debentures	18,558	1,272	6.85 %	17,487	1,041	5.95 %			0.00 %
Capital trust and other subordinated securities			0.00 %			0.00 %	10,589	685	6.47 %
Total interest-bearing liabilities	1,060,545	26,619	2.51 %	917,143	19,625	2.14 %	830,170	19,453	2.34 %
Noninterest-bearing deposits	174,173			168,960			141,438		
Other liabilities	16,492			7,229			6,123		
Total liabilities	1,251,210			1,093,332			977,731		
Shareholders' equity	95,922			74,704			69,010		
Total liabilities and shareholders' equity	\$ 1,347,132			\$ 1,168,036			\$ 1,046,741		
Net interest income		\$ 42,901			\$ 38,094			\$ 32,320	
Net interest rate spread			2.92 %			3.07 %			2.91 %
Net interest rate margin			3.35 %			3.44 %			3.28 %

Rate/Volume Analysis

The following table sets forth certain information regarding changes in the Company's interest income and interest expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in rate (changes in rate multiplied by old average balance) and (ii) changes in volume (changes in average balances multiplied by

old rate). The net change attributable to the combined impact of rate and volume was allocated proportionally to the individual rate and volume changes.

	Year ended December 31, 2005 vs. 2004			2004 vs. 2003		
	Increase/(decrease) due to Rate	Volume	Total	Increase/(decrease) due to Rate	Volume	Total
	(In thousands)					
Interest income:						
Overnight investments	\$ 124	\$ (61)	\$ 63	\$ 10	\$ (42)	\$ (32)
Investment securities	(132)	1,217	1,085	(53)	506	453
Mortgage-backed securities	223	3,381	3,604	435	388	823
Stock in the FHLB	199	140	339	(17)	63	46
Commercial loans and leases	1,519	3,404	4,923	(165)	3,763	3,598
Residential mortgage loans	118	(1,535)	(1,417)	(751)	161	(590)
Consumer and other loans	786	2,418	3,204	(230)	1,878	1,648
Total interest income	2,837	8,964	11,801	(771)	6,717	5,946
Interest expense:						
NOW accounts	(346)	(236)	(582)	(285)	94	(191)
Money market accounts	5	17	22	35	57	92
Savings accounts	677	158	835	(443)	299	(144)
Certificate of deposit accounts	1,111	2,213	3,324	(690)	412	(278)
Overnight & short-term borrowings	416	79	495	31	(14)	17
FHLB and other borrowings	(81)	2,750	2,669	(909)	1,229	320
Capital trust and other subordinated securities	164	67	231	(59)	415	356
Total interest expense	1,946	5,048	6,994	(2,320)	2,492	172
Net interest income	\$ 891	\$ 3,916	\$ 4,807	\$ 1,549	\$ 4,225	\$ 5,774

Comparison of Years Ended December 31, 2005 and December 31, 2004

General

Net income for 2005 increased \$955,000, or 11.1%, to \$9.6 million, from \$8.6 million for 2004. Earnings per diluted common share (EPS) was the same both years at \$2.04. The main factor for the same level of EPS was the dilutive effect of the issuance of approximately 628,000 shares in the second quarter of 2005. The 2005 earnings represented a return on average assets of 0.71% and a return on average equity of 9.98% for 2005, as compared to a return on average assets of 0.74% and a return on average equity of 11.53% for 2004.

Net Interest Income

For 2005, net interest income was \$42.9 million, compared to \$38.1 million for 2004. The net interest margin for 2005 was 3.35% compared to a net interest margin of 3.44% for 2004. The increase in net interest income of \$4.8 million, or 12.6%, was primarily attributable to the overall growth of the Company. Average earning assets increased \$172.4 million, or 15.6%, and average interest-bearing liabilities increased \$143.4 million, or 15.6%, over the preceding year. The decrease of 9 basis points in the net interest margin resulted primarily from compression in the interest rate environment, customer demand for higher-yielding term deposit products and the leverage program the Company undertook to partially offset the dilution of EPS caused by the issuance of additional common stock during the second quarter of 2005.

Interest Income Investments

Total investment income (consisting of interest on overnight investments, investment securities and MBSs, and dividends on FHLB stock) was \$15.7 million for 2005, compared to \$10.6 million for 2004. This increase in total investment income of \$5.1 million, or 48.0%, was attributable primarily to higher average balances in 2005. While yields on total investments increased moderately during 2005, the majority of the increase in investment income relates to the leverage program referred to above, which was concluded in the fourth quarter of 2005.

Interest Income Loans and Leases

Interest from loans was \$53.8 million for 2005, and represented a yield on total loans of 5.87%. This compares to \$47.1 million of interest, and a yield of 5.55%, for 2004. Increased interest income resulting from growth in the average balance of loans of \$67.7 million, or 8.0%, was augmented by an increase in the yield on loans of 32 basis points.

The average balance of the various components of the loan portfolio changed as follows: commercial loans and leases increased \$52.2 million, or 14.1%; consumer and other loans increased \$45.7 million, or 32.3%; and residential mortgage loans decreased \$30.2 million, or 8.9%. The yield on the various components of the loan portfolio changed as follows: commercial loans and leases increased 40 basis points, to 6.65%; consumer and other loans increased 52 basis points, to 5.42%; and residential mortgage loans increased 3 basis points, to 5.09%. The yields on loans and leases benefited primarily from the increases in short-term interest rates that occurred throughout 2005.

Interest Expense Deposits and Borrowings

Interest paid on deposits and borrowings increased by \$6.9 million, or 35.6%, as short-term market interest rates increased during the past year. The overall average cost for interest-bearing liabilities increased 37 basis points from 2.14% for 2004, to 2.51% for 2005. The average balance of total interest-bearing liabilities increased \$143.4 million, or 15.6%, from \$917.1 million in 2004, to \$1.06 billion in 2005. The growth in deposit average balances was centered primarily in certificate of deposit (CD) accounts (up \$79.2 million, or 35.1%) and savings accounts (up \$12.7 million, or 3.9%). These increases were somewhat offset by a decrease in NOW accounts (down \$28.8 million, or 23.4%). Money market accounts remained consistent with prior year average balances, increasing \$1.3 million, or 7.7%.

In addition, the Company increased its utilization of FHLB borrowings (up \$45.2 million, or 19.3%). The Company also entered into wholesale repurchase agreements in 2005, aggregating \$20 million by the end of the year. The cost of nondeposit borrowings increased 11 basis points in 2005 to 3.95%, compared to 3.84% in the prior year.

Customer demand for higher cost CDs and the longer-term funding required for the leverage program were the main drivers of both the overall average cost and average balance levels of interest-bearing liabilities. Liability costs are dependent on a number of factors including general economic conditions, national and local interest rates, competition in the local deposit marketplace, interest rate tiers offered and the Company's cash flow needs.

Provision for Loan and Lease Losses

The provision for loan and lease losses was \$1.5 million for 2005, compared to \$900,000 for 2004. The allowance, expressed as a percentage of total loans and leases, was 1.28% as of December 31, 2005, compared to 1.34% at the prior year-end and stood at 2932.1% of nonperforming loans and leases at December 31, 2005, compared to 1624.3% of nonperforming loans and leases at December 31, 2004. Net charge-offs for 2005 were \$1.2 million, compared to \$72,000 for 2004. The increase in net charge-offs

occurred largely during the second quarter and was attributable to one asset-based credit. To resolve the credit, the Bank sold the loan to a third party at a discount, resulting in a \$1.2 million charge-off.

Management evaluates several factors including new loan originations, actual and estimated charge-offs, risk characteristics of the loan and lease portfolio and general economic conditions when determining the provision for loan and lease losses. As the loan and lease portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of nonperforming assets will increase, which in turn may lead to increases to the provision for loan and lease losses. Also see discussion under *Allowance for Loan and Lease Losses* .

Noninterest Income

Total noninterest income increased \$693,000, or 8.1%, from \$8.6 million for 2004, to \$9.3 million for 2005. Excluding gains on sales of premises and equipment and net gains on investment sales, noninterest income increased \$1.1 million or 14.3%. Deposit account service charges continue to represent the largest source of noninterest income for the Company, showing modest growth of \$47,000, or 1.0%, to \$4.6 million for 2005, compared to \$4.5 million in the prior year. Loan related fees increased \$483,000, or 89.3%, as the Bank experienced a higher level of prepayments in 2005 than in the previous year. Additionally, growth occurred in commissions on loans originated for third parties, with an increase of \$113,000 from the prior year, or 159%. Commissions on leases originated for third parties of \$245,000 and sales of Rhode Island tax credits of \$220,000 were the key drivers to the growth in Other Income. On a net basis, gains on sales of investments and mortgage-backed securities were up moderately by \$91,000 from the prior year. These increases were offset by declines in commission on nondeposit investment products as income was down \$124,000, or 12.7%.

The following table sets forth the components of noninterest income:

	Year ended	
	December 31,	
	2005	2004
	(In thousands)	
Service charges on deposit accounts	\$ 4,561	\$ 4,514
Loan related fees	1,024	541
Commissions on nondeposit investment products	849	973
Income from bank-owned life insurance	691	641
Commissions on loans originated for others	184	71
Gain on sale of Investments/MBSs	181	90
Gain on sale of premises and equipment		535
Other income	1,784	1,216
Total noninterest income	\$ 9,274	\$ 8,581

Noninterest Expense

Noninterest expenses for 2005 increased a total of \$3.4 million, or 10.4%, to \$36.3 million. This increase was primarily due to higher operating costs resulting from the continued growth of the Company as the Bank opened two new branches in 2005 and acquired Macrolease. The increase was centered in the following areas: Salaries and employee benefits (up \$2.4 million, or 14.1%), Occupancy costs (up \$457,000, or 17.1%), Marketing (up \$155,000, or 10.8%), Loan workout (up \$107,000, or 97.3%) and Other expenses (up \$471,000, or 11.5%). The Company did experience decreases in Loan servicing (down \$124,000, or 11.4%) and Data processing (down \$73,000, or 2.6%). Professional services remained constant with 2004 levels, showing a moderate increase of \$52,000, or 2.6%, as costs incurred to comply with Sarbanes-Oxley Section 404 did not decrease. Overall, the Company's efficiency ratio decreased slightly to 69.56% for 2005, from 70.41% for 2004.

The following table sets forth the components of noninterest expense:

	Year ended December 31,	
	2005	2004
	(In thousands)	
Salaries and employee benefits	\$ 19,476	\$ 17,072
Occupancy and equipment	4,695	4,260
Data processing	2,759	2,832
Professional services	2,017	1,965
Marketing	1,584	1,429
Loan servicing	968	1,092
Loan workout and other real estate owned	217	110
Other expenses	4,576	4,105
Total noninterest expense	\$ 36,292	\$ 32,865

Income Tax Expense

The Company recorded income tax expense of \$4.8 million for 2005, compared to \$4.3 million for 2004. This represented total effective tax rates of 33.6% and 33.3%, respectively. Tax-favored income from BOLI, along with its utilization of a Rhode Island passive investment company, has reduced the Company's effective tax rate from the 40.9% combined statutory federal and state tax rates.

Comparison of Years Ended December 31, 2004 and December 31, 2003

General

Net income for 2004, increased \$1.4 million, or 19.4%, to \$8.6 million, or \$2.04 per diluted common share, from \$7.2 million, or \$1.77 per diluted common share, for 2003. This performance represented a return on average assets of 0.74% and a return on average equity of 11.53% for 2004, as compared to a return on average assets of 0.69% and a return on average equity of 10.45% for 2003.

Net Interest Income

For 2004, net interest income was \$38.1 million, compared to \$32.3 million for 2003. The net interest margin for 2004 was 3.44% compared to a net interest margin of 3.28% for 2003. The increase in net interest income of \$5.8 million, or 17.9%, was primarily attributable to the overall growth of the Company. Average earning assets increased \$120.9 million, or 12.3%, and average interest-bearing liabilities increased \$87.0 million, or 10.5%, over the preceding year. The increase of 16 basis points in the net interest margin resulted from the Company's assets benefiting from increases in the Prime Rate during 2004, while the Company also was able to reduce the overall cost of its interest-bearing liabilities. Additionally, prepayment activity slowed considerably from the 2003 period, resulting in an increase in the yield of mortgage-related assets.

Interest Income Investments

Total investment income (consisting of interest on overnight investments, investment securities and MBSs, and dividends on FHLB stock) was \$10.6 million for 2004, compared to \$9.3 million for 2003. This increase in total investment income of \$1.3 million, or 13.8%, was attributable to a 21 basis point increase in the overall yield on investments, from 3.89% in 2003, to 4.10% in 2004, in response to slower prepayment activity in MBSs, coupled with a \$19.6 million, or 8.2%, increase in the average balance of investments.

Interest Income Loans and Leases

Interest from loans was \$47.1 million for 2004, and represented a yield on total loans of 5.55%. This compares to \$42.5 million of interest, and a yield of 5.68%, for 2003. Increased interest income resulting from growth in the average balance of loans of \$101.4 million, or 13.6%, was partially offset by a decrease in the yield on loans of 13 basis points. The average balance of the various components of the loan portfolio changed as follows: commercial loans and leases increased \$60.2 million, or 19.5%; consumer and other loans increased \$38.1 million, or 36.9%; and residential mortgage loans increased \$3.1 million, or 0.9%. The yield on the various components of the loan portfolio changed as follows: commercial loans and leases decreased 6 basis points, to 6.25%; consumer and other loans decreased 22 basis points, to 4.90%; and residential mortgage loans decreased 22 basis points, to 5.28%. The decrease in the yield on loans and leases resulted primarily from a drop in market interest rates that occurred towards the end of 2003 and the beginning of 2004.

Interest Expense Deposits and Borrowings

Interest paid on deposits and borrowings remained stable, increasing only \$172,000, or 0.9%, as decreases in market interest rates occurred over the past year and were offset by growth in deposit and borrowing balances. The overall average cost for interest-bearing liabilities decreased 20 basis points from 2.34% for 2003, to 2.14% for 2004. Deposit costs are dependent on a number of factors including general economic conditions, national and local interest rates, competition in the local marketplace, interest rate tiers offered, and the Company's cash flow needs. Offsetting the effect of the decline in market interest rates, the average balance of interest-bearing liabilities increased \$87.0 million, or 10.5%, from \$830.2 million in 2003, to \$917.1 million in 2004. The growth in deposit average balances was centered in NOW accounts (up \$8.3 million, or 7.2%), savings accounts (up \$23.4 million, or 7.7%) and certificates of deposit accounts (up \$15.3 million, or 7.3%). In addition, the Company increased its utilization of FHLB borrowings (up \$30.1 million, or 18.4%) and subordinated securities (up \$6.9 million, or 65.1%).

Provision for Loan and Lease Losses

The provision for loan and lease losses was \$900,000 for 2004, compared to \$1.6 million for 2003. The allowance, expressed as a percentage of total loans and leases, was 1.34% as of December 31, 2004, compared to 1.36% at the prior year-end and stood at 1624.3% of nonperforming loans and leases at December 31, 2004, compared to 450.0% of nonperforming loans and leases at December 31, 2003. Net charge-offs for 2004 were \$72,000, compared to \$618,000 for 2003. Management evaluates several factors including new loan originations, actual and estimated charge-offs, risk characteristics of the loan and lease portfolio and general economic conditions when determining the provision for loan and lease losses. As the loan and lease portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of nonperforming assets will increase, which in turn may lead to increases to the provision for loan and lease losses. Also see discussion under *Allowance for Loan and Lease Losses*.

Noninterest Income

Total noninterest income decreased \$249,000, or 2.8%, from \$8.8 million for 2003, to \$8.6 million for 2004. Excluding net gains realized, noninterest income increased \$214,000, or 2.8%, as Service charges on deposit accounts (which continues to represent the largest source of noninterest income for the Company) increased \$599,000, or 15.3%, primarily as a result of enhancements to NSF item processing and increased debit card activity. Additionally, Commissions on nondeposit investment products increased \$98,000, or 11.2%, as consumer interest in investment products rebounded, and Other income increased \$257,000, or 26.8%, primarily from commissions generated from sales of tax credits, along with increased credit card and tuition payment activity. Partially offsetting these increases, Commissions on loans originated for

others declined \$284,000, or 80.0%, and prepayment penalties on commercial loans declined \$394,000, or 70.2%, from 2003 to 2004. Net Gains on sales of investment securities and MBSs were down \$998,000, or 91.7%, from 2003 to 2004. Also during 2004, the Bank sold its South Broadway, East Providence, office building (leasing back its branch office space). This transaction generated a total gain of \$755,000 of which \$511,000 was recognized and \$244,000 was deferred as a result of the sale-leaseback.

The following table sets forth the components of noninterest income:

	Year ended December 31,	
	2004	2003
	(In thousands)	
Service charges on deposit accounts	\$ 4,514	\$ 3,915
Commissions on nondeposit investment products	973	875
Income from bank-owned life insurance	641	723
Loan related fees	541	915
Commissions on loans originated for others	71	355
Gain on sale of Investments/MBSs	90	1,088
Gain on sale of premises and equipment	535	
Other income	1,216	959
Total noninterest income	\$ 8,581	\$ 8,830

Noninterest Expense

Noninterest expenses for 2004 increased a total of \$4.1 million, or 14.2%, to \$32.9 million. This increase was primarily due to higher operating costs resulting from the continued growth of the Company and was centered in the following areas: Salaries and employee benefits (up \$2.6 million, or 17.8%), Occupancy and equipment (up \$374,000, or 9.6%), Data processing (up \$55,000, or 2.0%), Marketing (up \$179,000, or 14.3%), Loan servicing (up \$58,000, or 5.6%) and Other expenses (up \$205,000, or 5.3%). In addition to increases resulting from continued growth of the Company, Salaries and employee benefits for 2004 included additional incentive bonus accruals of \$1.2 million that were not present in 2003. Also, Professional services increased \$591,000, or 43.0%, during 2004 as the Company incurred costs for management training (\$145,000), partial outsourcing of its internal audit function (\$185,000) and Sarbanes-Oxley Section 404 compliance (\$200,000) that were not present in 2003. The Company expects that the costs incurred to comply with Sarbanes-Oxley Section 404 during 2004 will be incurred annually in future years. Overall, the Company's efficiency ratio increased slightly to 70.41% for 2004, from 69.96% for 2003.

The following table sets forth the components of noninterest expense:

	Year ended December 31,	
	2004	2003
	(In thousands)	
Salaries and employee benefits	\$ 17,072	\$ 14,496
Occupancy and equipment	4,260	3,886
Data processing	2,832	2,777
Marketing	1,429	1,250
Professional services	1,965	1,374
Loan servicing	1,092	1,034
Other real estate owned	110	73
Other expenses	4,105	3,900
Total noninterest expense	\$ 32,865	\$ 28,790

Income Tax Expense

The Company recorded income tax expense of \$4.3 million for 2004, compared to \$3.5 million for 2003. This represented total effective tax rates of 33.3% and 33.0%, respectively. Tax-favored income from BOLI, along with its utilization of a Rhode Island passive investment company, has reduced the Company's effective tax rate from the 40.9% combined statutory federal and state tax rates.

Financial Condition

Loans and Leases Receivable

Total loans and leases were \$950.8 million, or 65.9% of total assets, at December 31, 2005, compared to \$886.3 million, or 71.5% of total assets, at December 31, 2004, an increase of \$64.5 million, or 7.4%. This increase is centered in commercial and consumer loans (where the Company concentrates its origination efforts) and was partially offset by a slight decrease in residential mortgage loans (which the Company primarily purchases). Total loans and leases as of December 31, 2005 are segmented in three broad categories: commercial loans and leases that aggregate \$438.3 million or 46.1% of the portfolio; residential mortgages that aggregate \$306.0 million, or 32.2% of the portfolio; and consumer and other loans that aggregate \$206.5 million, or 21.7% of the portfolio.

The Company utilizes the term "small business loans" to describe business lending relationships of approximately \$250,000 or less.

The following is a summary of loans and leases receivable:

	December 31, 2005 (In thousands)	2004	2003	2002	2001
Commercial loans and leases:					
Commercial real estate owner occupied	\$ 112,987	\$ 93,027	\$ 77,317	\$ 59,249	\$ 46,698
Commercial real estate nonowner occupied	95,779	90,716	78,083	81,242	73,369
Commercial & industrial	73,620	78,918	67,925	57,389	53,677
Small business	38,641	37,820	30,429	28,750	24,122
Multi-family	33,725	32,415	28,730	18,952	14,927
Construction	37,772	32,319	30,632	18,101	14,027
Leases and other	49,342	38,116	19,548	17,613	12,715
Subtotal	441,866	403,331	332,664	281,296	239,535
Discount on leases acquired	(3,366)	(226)			
Net deferred loan origination fees	(191)	(335)	(398)	(329)	(171)
Total commercial loans and leases	438,309	402,770	332,266	280,967	239,364
Residential mortgage loans:					
One- to four-family adjustable rate	202,223	199,031	232,543	277,265	285,589
One- to four-family fixed rate	101,598	115,350	131,743	19,310	23,306
Subtotal	303,821	314,381	364,286	296,575	308,895
Premium on loans acquired	2,257	1,826	2,026	1,248	1,381
Net deferred loan origination fees	(62)	(72)	(82)	(60)	(64)
Total residential mortgage loans	306,016	316,135	366,230	297,763	310,212
Consumer and other loans:					
Home equity term loans	134,932	110,542	68,523	47,906	22,930
Home equity lines of credit	67,959	53,551	42,067	37,381	28,460
Automobile	157	488	1,455	3,409	6,335
Installment	365	491	662	967	1,240
Savings secured	358	439	631	602	656
Unsecured and other	1,271	801	1,787	1,063	1,153
Subtotal	205,042	166,312	115,125	91,328	60,774
Premium on loans acquired	2	15	44	103	192
Net deferred loan origination costs	1,437	1,069	617	497	422
Total consumer and other loans	206,481	167,396	115,786	91,928	61,388
Total loans and leases receivable	\$ 950,806	\$ 886,301	\$ 814,282	\$ 670,658	\$ 610,964

Commercial loans and leases During 2005, the commercial loan and lease portfolio (consisting of commercial real estate, commercial & industrial, equipment leases, multi-family real estate, construction and small business loans) increased \$35.5 million, or 8.8%. The primary drivers of this growth occurred in the commercial real estate and equipment leasing areas.

The Company believes it is well positioned for continued commercial growth. Particular emphasis is placed on generation of small- to medium-sized commercial relationships (those relationships with \$7.0 million or less in total loan commitments). Unlike most community banks, the Bank is able to offer asset-based commercial loan facilities that monitor advances against receivables and inventories on a formula basis.

The Bank is also active in small business lending in which it utilizes credit scoring, in conjunction with traditional review standards, and employs streamlined documentation. Small business loans represented

8.9% of the commercial loan and lease portfolio at December 31, 2005. The Bank is a participant in the U.S Small Business Administration (SBA) Preferred Lender Program in both Rhode Island and Massachusetts.

The Bank historically has purchased equipment leases from originators outside of the Bank. The principal lessees were the U.S Government and its agencies for the vast majority of leases. These government leases generally have maturities of five years or less and are not dependent on residual collateral values. With the addition of Macrolase in the second quarter of 2005, the Bank is now originating equipment leases for its own portfolio, as well as originating leases for third parties as a new source of noninterest income. At December 31, 2005, leases totaled \$46.1 million, or 10.5% of the commercial loan and lease portfolio, with \$25.8 million of government leases and \$20.3 million of Macrolase-generated leases.

Residential mortgage loans Residential mortgage loans decreased \$10.1 million, or 3.2%, as repayments (\$71.2 million) exceeded the total of purchases (\$56.5 million) and originations (\$5.0 million). Since inception, the Bank has concentrated its portfolio lending efforts on commercial and consumer lending opportunities, but originates mortgage loans for its own portfolio on a limited basis. The Bank does not employ any outside mortgage originators, but from time to time, purchases residential mortgage loans from third-party originators. Until such time as the Bank can originate sufficient commercial and consumer loans to utilize available cash flow, it intends to continue purchasing residential mortgage loans as opportunities develop.

Consumer loans During 2005, consumer loan outstandings increased \$39.1 million, or 23.3%, to \$206.5 million at December 31, 2005, from \$167.4 million at December 31, 2004. The Company believes that these ten- and fifteen-year fixed-rate products, along with the floating lines of credit, possess attractive cash flow characteristics in the current interest rate environment and the Company anticipates that growth in these products will continue.

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The table below shows loan and lease originations, purchases, sales and repayment activities. Included within residential mortgage loan repayments is amortization of premium on purchased residential mortgages.

	Year ended December 31,		2003	2002	2001
	2005	2004			
	(In thousands)				
Originations and principal additions:					
Loans and leases purchased:					
Commercial loans and leases	\$ 9,243	\$ 3,257	\$	\$	\$
Residential mortgage loans	56,512	55,273	249,656	166,935	186,013
Consumer and other loans					4,902
Total loans and leases purchased	65,755	58,530	249,656	166,935	190,915
Loans and leases originated:					
Commercial loans and leases	99,490	109,560	106,335	84,132	59,186
Residential mortgage loans	5,009	9,635	28,371	9,345	18,037
Consumer and other loans	82,426	90,655	65,831	51,951	22,332
Total loans and leases originated	186,925	209,850	200,537	145,428	99,555
Principal reductions:					
Net charge-offs/transfers to OREO:					
Commercial loans and leases	(1,205)	(98)	(565)	(400)	(981)
Residential mortgage loans				(58)	(304)
Consumer and other loans	(7)	(51)	(64)	(93)	(61)
Total net charge-offs/transfers to OREO	(1,212)	(149)	(629)	(551)	(1,346)
Principal payments:					
Commercial loans and leases	(72,736)	(42,052)	(54,402)	(41,971)	(31,631)
Residential mortgage loans	(71,249)	(114,813)	(210,316)	(188,542)	(141,657)
Consumer and other loans	(42,978)	(39,417)	(41,970)	(21,304)	(23,928)
Total principal payments	(186,963)	(196,282)	(306,688)	(251,817)	(197,216)
Change in total loans and leases receivable (before net items)	\$ 64,505	\$ 71,949	\$ 142,876	\$ 59,995	\$ 91,908

The following table sets forth certain information at December 31, 2005, regarding the aggregate dollar amount of certain loans maturing in the loan portfolio based on scheduled payments to maturity. Actual loan principal payments may vary from this schedule due to refinancings, modifications and other changes in loan terms. Demand loans and loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less.

	Principal repayments contractually due		
	One year or less (In thousands)	After one, but within five years	After five years
Construction/permanent loans	\$ 23,420	\$ 7,401	\$ 6,951
Commercial & industrial loans (including leases)	41,434	56,707	21,547
Home equity lines of credit	77	56	68,469
Interest-only residential first mortgages			33,248
Small business loans	16,054	14,373	8,214
Total	\$ 80,985	\$ 78,537	\$ 138,429

The following table sets forth as of December 31, 2005, the dollar amount of certain loans due after one year that have fixed interest rates or floating or adjustable interest rates.

	Loans due after one year	
	Fixed rates (In thousands)	Floating or adjustable rates
Construction/permanent loans	\$ 5,044	\$ 9,308
Commercial & industrial loans (including leases)	63,926	14,328
Home equity lines of credit		68,525
Interest-only residential first mortgages	4,859	28,389
Small business loans	12,647	9,940
Total	\$ 86,476	\$ 130,490

Asset Quality

The definition of nonperforming assets includes nonperforming loans and Other real estate owned (OREO). OREO consists of real estate acquired through foreclosure proceedings and real estate acquired through acceptance of a deed in lieu of foreclosure. Nonperforming loans are defined as nonaccrual loans, loans past due 90 days or more, but still accruing and impaired loans. Under certain circumstances, the Company may restructure the terms of a loan as a concession to a borrower. These restructured loans are considered impaired loans. Included in nonaccrual loans at December 31, 2005, 2004 and 2003, were \$141,000, \$671,000 and \$2.1 million of impaired loans, respectively.

Nonperforming Assets At December 31, 2005, the Company had nonperforming assets of \$415,000, or 0.03%, of total assets. This compares to nonperforming assets of \$733,000 or 0.06% of total assets, at December 31, 2004, and nonperforming assets of \$2.5 million, or 0.23% of total assets, at December 31, 2003. Nonperforming assets at December 31, 2005, consisted of commercial loans aggregating \$235,000, consumer loans aggregating \$61,000 and residential mortgage loans aggregating \$119,000. Nonperforming assets at December 31, 2004 and 2003 were primarily comprised of nonaccrual commercial loans and nonaccrual residential mortgage loans. The Company evaluates the underlying collateral of each nonperforming asset and continues to pursue the collection of interest and principal. Management believes that the December 31, 2005 level of nonperforming assets is low relative to the size of the Company's loan portfolio. As the loan portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of nonperforming assets will increase, as will its level of charged-off loans.

The following table sets forth information regarding nonperforming assets.

	December 31,					
	2005	2004	2003	2002	2001	
	(Dollars in thousands)					
Nonaccrual loans	\$ 415	\$ 733	\$ 2,462	\$ 736	\$ 753	
Loans past due 90 days or more, but still accruing						
Impaired loans (not included in nonaccrual loans)						
Total nonperforming loans	415	733	2,462	736	753	
Other nonperforming assets				58	264	
Total nonperforming assets	\$ 415	\$ 733	\$ 2,462	\$ 794	\$ 1,017	
Nonperforming loans as a percent of total loans and leases	0.04	% 0.08	% 0.30	% 0.11	% 0.12	%
Nonperforming assets as a percent of total assets	0.03	% 0.06	% 0.23	% 0.08	% 0.12	%

Nonaccrual Loans *Accrual* of interest income on all loans is discontinued when concern exists as to the collectibility of principal or interest, or typically when a loan becomes over 90 days delinquent. Additionally, when a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period income. Residential mortgage loans are removed from nonaccrual when they become less than 90 days past due, and in the case of commercial and consumer loans, when concern no longer exists as to the collectibility of principal or interest. Interest collected on nonaccruing loans is either applied against principal or reported as income according to management's judgment as to the collectibility of principal. At December 31, 2005, nonaccrual loans totaled \$415,000. Interest on nonaccrual loans that would have been recorded as additional income for the year ended December 31, 2005, had the loans been current in accordance with their original terms, totaled \$23,000. This compares with \$29,000 and \$298,000 of foregone interest income on nonaccrual loans for the years ended December 31, 2004 and 2003, respectively.

The following table sets forth certain information regarding nonaccrual loans.

	December 31, 2005			2004			2003	
	Principal Balance (Dollars in thousands)	Percent of Total Loans		Principal Balance	Percent of Total Loans		Principal Balance	Percent of Total Loans
Nonaccrual loans:								
Commercial loans and leases	\$ 235	0.02 %	\$	709	0.08 %	\$	2,256	0.28 %
Residential mortgage loans	119	0.01 %	\$	24	0.00 %	\$	186	0.02 %
Consumer and other loans	61	0.01 %			0.00 %		20	0.00 %
Total nonaccrual loans	\$ 415	0.04 %	\$	733	0.08 %	\$	2,462	0.30 %

Delinquencies At December 31, 2005, \$5.3 million of loans were 30 to 89 days past due. This compares to \$4.9 million and \$943,000 of loans 30 to 89 days past due as of December 31, 2004 and 2003, respectively. The majority of these loans at December 31, 2005 and 2004 were commercial loans and at December 31, 2003 were residential mortgage loans.

Management reviews delinquent loans frequently to assess problem situations and to quickly address these problems. In the case of consumer and commercial loans, the Bank contacts the borrower when a loan becomes delinquent. When a payment is not made, generally within 10-15 days of the due date, a late charge is assessed. After 30 days of delinquency, a notice is sent to the borrower advising that failure to cure the default may result in formal demand for payment in full. In the event of further delinquency, the matter is generally referred to legal counsel to commence civil proceedings to collect all amounts owed. In the case of residential mortgage loans, delinquency and collection proceedings are conducted by either the Bank, or its mortgage servicers, in accordance with standard servicing guidelines. In any circumstance where the Bank is secured by real property or other collateral, the Bank enforces its rights to the collateral in accordance with applicable law.

The following table sets forth information as to loans delinquent for 30 to 89 days.

	December 31, 2005		2004		2003	
	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans
(Dollars in thousands)						
Loans delinquent for 30 to 59 days:						
Commercial loans and leases	\$ 4,509	0.48 %	\$ 3,370	0.38 %	\$ 49	0.01 %
Residential mortgage loans	399	0.04 %	951	0.11 %	250	0.03 %
Consumer and other loans	139	0.01 %	549	0.06 %	47	0.01 %
Total loans delinquent 30 to 59 days	5,047	0.53 %	4,870	0.55 %	346	0.05 %
Loans delinquent for 60 to 89 days:						
Commercial loans						
Residential mortgage loans	299	0.03 %			597	0.07 %
Consumer and other loans						
Total loans delinquent 60 to 89 days	299	0.03 %			597	0.07 %
Total loans delinquent 30 to 89 days	\$ 5,346	0.56 %	\$ 4,870	0.55 %	\$ 943	0.12 %

Adversely Classified Assets The Company's management adversely classifies certain assets as substandard, doubtful or loss based on criteria established under banking regulations. An asset is considered substandard if inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if existing deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

At December 31, 2005, the Company had \$6.8 million of assets that were classified as substandard. This compares to \$5.8 million and \$5.5 million of assets that were classified as substandard at December 31, 2004 and 2003, respectively. The Company had no assets that were classified as loss or doubtful at any of these dates. Performing loans may or may not be adversely classified depending upon management's judgment with respect to each individual loan. At December 31, 2005, included in the \$6.8 million of assets that were classified as substandard, were \$6.4 million of performing loans. This compares to \$5.1 million and \$3.1 million of adversely classified performing assets as of December 31, 2004 and 2003, respectively. These amounts constitute assets that, in the opinion of management, could potentially migrate to nonperforming or doubtful status. Management believes that the December 31, 2005 level of adversely classified assets is low relative to the size and composition of the Company's loan portfolio. As the loan and lease portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of adversely classified assets will increase. This in turn may necessitate an increase to the provision for loan and lease losses in future periods.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses is established for credit losses inherent in the loan portfolio through a charge to earnings. Loans deemed uncollectible are charged against the allowance, while

recoveries of amounts previously charged-off are added to the allowance. Amounts are charged-off once the probability of loss has been established, with consideration given to such factors as the customer's financial condition, underlying collateral and guarantees, and general and industry economic conditions.

When an insured institution classifies problem loans as either substandard or doubtful, it is required to establish allowances for loan losses in an amount deemed prudent by management. Additionally, general allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities, and have not been allocated to particular problem loans.

The following table represents the allocation of the allowance for loan and leases losses as of the dates indicated:

	December 31, 2005		2004		2003		2002		2001	
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)									
Commercial loans and leases	\$ 7,240	46.1 %	\$ 6,503	45.4 %	\$ 4,761	40.8 %	\$ 5,250	41.9 %	\$ 4,191	39.2 %
Residential mortgage loans	1,653	32.2 %	1,644	35.7 %	1,922	45.0 %	1,757	44.4 %	1,835	50.8 %
Consumer and other loans	2,159	21.7 %	1,745	18.9 %	1,248	14.2 %	1,027	13.7 %	787	10.0 %
Unallocated	1,116	NA	2,014	NA	3,147	NA	2,062	NA	1,711	NA
Total	\$ 12,168	100.0 %	\$ 11,906	100.0 %	\$ 11,078	100.0 %	\$ 10,096	100.0 %	\$ 8,524	100.0 %

Assessing the appropriateness of the allowance for loan and leases losses involves substantial uncertainties and is based upon management's evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing various factors. Management's methodology to estimate loss exposure includes an analysis of individual loans deemed to be impaired, reserve allocations for various loan types based on payment status or loss experience and an unallocated allowance that is maintained based on management's assessment of many factors including the growth, composition and quality of the loan portfolio, historical loss experiences, general economic conditions and other pertinent factors. Based on this evaluation, management believes that the year-end allowance for loan and lease losses is appropriate.

A portion of the allowance for loan and lease losses is not allocated to any specific segment of the loan portfolio. This non-specific allowance is maintained for two primary reasons: (i) there exists an inherent subjectivity and imprecision to the analytical processes employed, and (ii) the prevailing business environment, as it is affected by changing economic conditions and various external factors, may impact the portfolio in ways currently unforeseen. Management, therefore, has established and maintains a non-specific allowance for loan losses. The amount of this measurement imprecision allocation was \$1.1 million at December 31, 2005, compared to \$2.0 million at December 31, 2004.

While management evaluates currently available information in establishing the allowance for loan and lease losses, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution's allowance for loan and lease losses and carrying amounts of other real estate owned. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

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During 2005, 2004 and 2003, the Bank made additions to the allowance of \$1.5 million, \$900,000 and \$1.6 million and experienced net charge-offs of \$1,212,000, \$72,000 and \$618,000, respectively. At December 31, 2005, the allowance for loan and leases losses stood at \$12.2 million and represented 2932% of nonperforming loans and 1.28% of total loans outstanding. This compares to an allowance for loan and lease losses of \$11.9 million, representing 1624% of nonperforming loans and 1.34% of total loans outstanding at December 31, 2004.

An analysis of the activity in the allowance for loan and lease losses is as follows:

	Year ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands)				
Balance at beginning of year	\$ 11,906	\$ 11,078	\$ 10,096	\$ 8,524	\$ 7,294
Loans charged-off:					
Commercial loans and leases	(1,266)	(98)	(565)	(400)	(406)
Residential mortgage loans			(17)		
Consumer and other loans	(8)	(52)	(64)	(93)	(61)
Total loans charged-off	(1,274)	(150)	(646)	(493)	(467)
Recoveries of loans previously charged-off:					
Commercial loans and leases	61	70	4	110	
Residential mortgage loans				40	
Consumer and other loans	1	8	24	40	28
Total recoveries of loans previously charged-off	62	78	28	190	28
Net (charge-offs) recoveries	(1,212)	(72)	(618)	(303)	(439)
Provision for loan losses charged against income	1,474	900	1,600	1,875	1,669
Balance at end of year	\$ 12,168	\$ 11,906	\$ 11,078	\$ 10,096	\$ 8,524
Net charge-offs (recoveries) to average loans outstanding	0.13	% 0.01	% 0.08	% 0.05	% 0.08

Investments

Total investments (consisting of overnight investments, investment securities, MBSs, and FHLB stock) totaled \$412.2 million, or 28.6% of total assets, at December 31, 2005. This compares to total investments of \$291.9 million, or 23.6% of total assets, as of December 31, 2004. The increase of \$120.3 million, or 41.2%, was centered in growth in the investment securities, \$46.4 million, and MBSs, \$74.9 million. All \$385.8 million of investment securities and MBSs at December 31, 2005 and 2004 were classified as securities available for sale. At December 31, 2005, the investment portfolio carried a total net unrealized loss of \$5.0 million, compared to \$1.0 million of net unrealized gains at December 31, 2004, with the primary driver of the change in unrealized gain/loss being the impact of rising interest rates.

The increase in total investments was driven by two primary factors. First, leverage transactions were entered into during the second, third and fourth quarters of 2005. These transactions were undertaken to partially offset the dilution in EPS resulting from the issuance of additional common stock during the second quarter of 2005. Second, cash flows were temporarily held in investments before being redeployed in the Bank's loan portfolio and market conditions made purchases of MBSs generally more attractive than purchases of residential whole mortgage loans.

A summary of investment and mortgage-backed securities available for sale follows:

	Amortized Cost (In thousands)	Unrealized Gains	Losses	Fair Value
At December 31, 2005:				
U.S. Agency obligations	\$ 125,915	\$	\$ (1,921)	\$ 123,994
Corporate debt securities	21,214	57	(608)	20,663
Trust preferred securities	6,199	108	(5)	6,302
U.S. Agency mortgage-backed securities	174,542	404	(1,486)	173,460
Collateralized mortgage obligations	62,907		(1,509)	61,398
Total	\$ 390,777	\$ 569	\$ (5,529)	\$ 385,817
At December 31, 2004:				
U.S. Agency obligations	\$ 74,330	\$ 219	\$ (358)	\$ 74,191
Corporate debt securities	25,388	528	(43)	25,873
Trust preferred securities	4,235	301		4,536
U.S. Agency mortgage-backed securities	97,210	1,082	(333)	97,959
Collateralized mortgage obligations	62,371	52	(436)	61,987
Total	\$ 263,534	\$ 2,182	\$ (1,170)	\$ 264,546
At December 31, 2003:				
U.S. Agency obligations	\$ 57,855	\$ 226	\$ (153)	\$ 57,928
Corporate debt securities	34,704	1,415		36,119
Trust preferred securities	4,269	283	(4)	4,548
U.S. Agency mortgage-backed securities	48,878	629	(26)	49,481
Collateralized mortgage obligations	57,150	254	(267)	57,137
Total	\$ 202,856	\$ 2,807	\$ (450)	\$ 205,213

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The following table sets forth the contractual maturities of investment and mortgage-backed securities available for sale and the weighted average yields of such securities:

	Within one year		After one, but within five years		After five, but within ten years		After ten years	
	Fair value (Dollars in thousands)	Weighted average yield	Fair value	Weighted average yield	Fair value	Weighted average yield	Fair value	Weighted average yield
At December 31, 2005:								
U.S. Agency obligations	\$ 14,815	2.81 %	\$ 109,179	4.11 %	\$	0.00 %	\$	0.00 %
Corporate debt securities	5,045	4.94 %	15,618	4.86 %		0.00 %		0.00 %
Trust preferred securities		0.00 %		0.00 %		0.00 %	6,302	7.34 %
U.S. Agency mortgage-backed securities		0.00 %		0.00 %	18,613	4.55 %	154,847	4.62 %
Collateralized mortgage obligations		0.00 %						