

BANCORP RHODE ISLAND INC  
Form 10-K  
March 09, 2007

**UNITED STATES  
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, 2006

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

## Edgar Filing: BANCORP RHODE ISLAND INC - Form 10-K

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 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, 2006, 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 Global Select Market SM was \$143,973,245.

As of February 28, 2007, there were 4,829,430 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 2007 Annual Meeting of Shareholders are incorporated by reference into Parts II and III of this Form 10-K.

See pages 61 to 63 for the exhibit index.

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**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, two national and one regional. Based on total deposits as of June 30, 2006 (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 its customers a wide range of business, commercial real estate, consumer and residential loans and leases, deposit products, nondeposit investment products, cash

management and online banking services, private banking 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, who 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 and added sales of investment products; more recently the Bank has added a private banking group and acquired an equipment leasing company.

In March 2006, the Bank marked its 10th anniversary in business. During those 10 years, the Company has grown its assets, deposits and customer base significantly and has expanded the depth and breadth of its management team and staff. Also, the Bank has substantially enlarged and improved its branch network, enhanced its operating systems and infrastructure and has become an effective competitive force in the Greater Providence marketplace.

The past year represented a watershed year for the Company. It marked the beginning of the Company's transition from a young, high growth *de novo* bank into a more mature institution, which seeks to better leverage the footprint it has built and investments it has made over its first ten years. Thus, the Company sought to combine its strong external focus on high quality loan and deposit growth, with (i) the absorption of the Company's major 2005 and 2004 initiatives, which included three new branches (with our branch network now expanded into Washington County), the creation of a private bank and acquisition of a leasing subsidiary, (ii) the deployment of the \$21.5 million of net capital raised in April 2005 and (iii) internally directed efforts to both rationalize the Company's organizational structure and better control operational costs. Additionally, the Company took measurable steps to deal with the industry-wide pressure on net interest margins presented by the flat-to-inverted yield curve and the intensified competition for deposits. The Company believes that the measures adopted have improved the Company's

internal operations, increased the value of the franchise and positioned the Company for greater success in the years to come.

In 2005, the Company realigned its executive management ranks. By the end of 2006, each of the proxy officers had at least a year's experience in their respective new positions and were functioning effectively as a team. In 2006, the Company added to the next tier of management, including commercial lending, information technology and marketing and invested in its security and audit functions. In the commercial lending area, the Company recruited a new director of corporate banking and a new head of business lending, both of whom had strong track records locally at one of the major national banks. Both of these senior managers were added to the Company without any loss of the existing talent in the Bank's pace-setting commercial lending group, which continued to achieve market-leading results.

The commercial lending group produced commercial loan growth of 18.6% in 2006, with commercial loan outstandings increasing from \$438.3 million at the prior year-end to \$519.8 million at December 31, 2006. Two of the initiatives begun by the Company in 2005 contributed to this growth. The Company's equipment leasing subsidiary, Macrolease, has contributed high-quality, high-yielding assets to the Company's balance sheet, as well as provided a new source of fee income from lease originations for third parties. In addition, the Company's private banking group is attracting more high net worth individuals, including professionals, to the Bank's customer base.

The Company's loan and lease growth did not come at the expense of credit quality as the Bank's credit culture remained strong. Nonperforming assets were minimal at December 31, 2006 at 0.14% of total loans and 0.10% of total assets, respectively.

Competition for deposits remained intense in the Bank's primary market area. However, the Bank's focus on core deposits drove increases in demand deposit accounts of \$15.2 million, or 8.2%, year-over-year. At December 31, 2006, total deposits increased \$35.5 million, or 3.6%, from the December 31, 2005 balance of \$981.0 million. Additionally, the deposit base at the Bank's newest branches continues to grow. Total deposits at the Bank's North Kingstown branch exceed \$40 million, while the Lincoln branch is ahead of plan at \$27 million and East Greenwich has attained \$16 million in total deposits. As is typical industry-wide, the deposit mix and yield curve have lengthened the time required for these branches to achieve profitability.

During 2006, the Bank also implemented deposit fee enhancement programs. As a result of these programs and the demand deposit account growth referred to above, the Bank experienced a 10.8% increase in deposit fee income over the course of the year.

In late 2006, the Bank also announced its plans to adopt a new service model for its branches. The Company plans to move toward the Universal Banker model, a single in-branch touch point for all banking services, which removes the traditional split between the teller and customer service representative. By having one person service the customer's needs, the Bank believes it will elevate its service levels as well as improve operational efficiencies. This concept will be phased in gradually throughout 2007.

There also was increased activity in the treasury and finance area in 2006. The Bank expanded its funding options and the finance group undertook stronger investor relations efforts. Additionally, the Company restructured a portion of its investment portfolio in September 2006 to improve earnings in future periods by capitalizing on a temporary increase in security valuations due to movements in the yield curve. The Company sold \$62 million of its available for sale securities and reinvested the sales proceeds into higher-yielding securities. This investment portfolio restructuring resulted in pretax losses of \$859,000; however, the effect of these security losses on shareholders' equity was minimal as the securities had been carried at market value on the balance sheet. As a result of this investment portfolio repositioning, the Company anticipates an increase of future pretax interest income of over \$900,000 by the end of 2007.

In late 2005, the Bank began a detailed examination of its operational processes and procedures. The intention was to move from evolved to engineered processes. As a result, by September 2006, the Company was able to eliminate 24 positions, primarily in its back office. Additionally, in the latter part of 2006, the Company created a loan services unit (LSU). The LSU will handle underwriting, processing and monitoring of business credit relationships up to \$1 million. The Company is streamlining its approach for smaller credits with the objectives of improved monitoring and more efficient processing of these credits. The Company's process review continues in a number of areas and the Company expects to gain additional efficiencies over time. Throughout 2007, management plans to significantly limit growth of noninterest expenses as the Company expects margin pressure to persist.

### **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. The Bank has allocated substantial resources to its commercial and consumer lending functions to facilitate and promote such growth. From December 31, 2001, until December 31, 2006, commercial loan and lease outstandings have increased \$280.4 million, or 117.2%, and consumer loan outstandings have increased \$159.2 million, or 259.3%. Commercial loans and leases increased from 39.2% of total loans and leases at December 31, 2001, to 51.8% of total loans and leases at December 31, 2006, and consumer and other loans increased from 10.0% of total loans and leases at December 31, 2001, to 22.0% of total loans and leases at December 31, 2006. Meanwhile, residential mortgage loans decreased from 50.8% of total loans and leases at December 31, 2001, to 26.3% of total loans and leases at December 31, 2006.

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 66% of Rhode Island businesses and 74% of Rhode Island jobs are located in Providence and Kent Counties. More than 98% 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.

For most of 2006, the Bank's commercial lending function was 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 business loans, often referred to as commercial and industrial loans, including owner-occupied commercial real estate loans, term loans, revolving lines of credit and equipment leases (through the Bank's subsidiary, Macrolease). The third group is the business development group (formerly the small business group), responsible for origination of a variety of real estate and non-real estate loans for business lending relationships of approximately \$250,000 or less, also referred to as small business loans. (The Bank's branch network also plays a role in the origination of small business loans.)

In the latter part of 2006, the Bank reorganized its commercial business lending function, changing responsibilities and creating one more group. The business lending group now concentrates its efforts on relationships in excess of \$1 million. Business lending relationships under \$1 million are now generally originated by the Bank's business development group, which formerly concentrated solely on small business loans. Underwriting, processing and monitoring of the bulk of business credit relationships of under \$1 million have moved to the newly created LSU. The Company is streamlining its approach for smaller credits with the objectives of improved monitoring and more efficient processing of these credits.

The Bank also 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 \$1.25 million. All extensions of credit of more than \$1.25 million (up to the Bank's house lending limit of \$10.0 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, 2006, the Bank had \$229.5 million of aggregate loan commitments outstanding to fund a variety of loans.

Overall, loans and leases produced total interest income of \$63.0 million, or 77.6% of total interest and dividend income, in 2006 and \$53.8 million, or 77.4%, of total interest and dividend income, during 2005.

*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, 2006, owner-occupied commercial real estate loans totaled \$140.8 million, or 14.0% 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 \$102.4 million, or 10.2% of the total loan portfolio, and multi-family residential loans totaled \$34.3 million, or 3.4% 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 permanent 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. Additionally, through the newly established LSU, the Bank is expanding its use of credit scoring in evaluating business loans of up to \$750,000. 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, 2006, commercial and industrial loans totaled \$106.0 million, or 10.6% 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, may fluctuate in value based on the success of the business and may deteriorate over time.

*Leases* With the Macrolease platform, the Bank originates equipment leases for its own portfolio, as well as originating leases for third parties as a source of noninterest income. In addition, the Bank historically has purchased equipment leases from originators outside of the Bank. The U.S. Government and its agencies are the principal lessees on the vast majority of these purchased leases. These government leases generally have maturities of five years or less and are not made in reliance on residual collateral values. At December 31, 2006, leases totaled \$56.3 million, or 10.8% of the commercial loan and lease portfolio, with \$32.4 million of Macrolease-generated leases and \$23.9 million of government 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, 2006, small business loans totaled \$41.8 million, or 4.2% 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. 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, 2006, outstanding construction loans totaled \$37.2 million, or 3.7% of the total loan portfolio. In addition, 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. The Bank generally requires from the borrower evidence of either pre-sale or pre-lease commitments on certain percentages of the construction project for which the loan is made.

*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 fully utilize available cash flows. With the exception of one pool of mortgages of approximately \$28 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, 2006, approximately 30% 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 2006, fees from these loans originated for third parties decreased to \$159,000 from \$184,000 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, 2006, one- to four-family residential mortgage loans totaled \$264.0 million, or 26.3% of the total loan portfolio. The fixed rate portion of this portfolio totaled \$96.1 million and had original maturities of 15 to 30 years. The adjustable rate portion of this portfolio totaled \$167.9 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, 2006, the consumer loan portfolio totaled \$220.6 million, or 22.0% 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 \$397.7 million, or 26.9% of total assets, as of December 31, 2006. 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.

In September 2006, the Company restructured a portion of its investment portfolio to improve earnings in future periods by capitalizing on a temporary increase in security valuations due to movements in the yield curve. The Company sold \$62 million of its available for sale securities and reinvested the sales proceeds into higher-yielding securities. This investment portfolio restructuring resulted in pretax losses of \$859,000; however, the effect of these security losses on shareholders' equity was minimal as the securities had been carried at market value on the balance sheet. As a result of this investment portfolio repositioning, the Company anticipates an increase of future pretax interest income of over \$900,000 by the end of 2007.

Overall, in 2006, investments produced total interest and dividend income of \$18.2 million, or 22.4% of total interest and dividend income compared to \$15.7 million, or 22.6%, of total interest and dividend income, during 2005.

### **Deposits**

Deposits are the principal source of funds for use in lending and for other general business purposes. The Bank attracts deposits from businesses, non-profit entities, governmental entities 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 increased moderately on a dollar amount basis compared to the prior year (up \$6.8 million, or 1.1%). Within core deposits, the Bank increased demand deposit accounts to \$200.3 million at December 31, 2006 from \$185.1 million at December 31, 2005. Within total deposit growth, however, the balance sheet mix changed from the prior year due to the continuing growth of CD balances. Core deposits as percentage of total deposits decreased to 62.4% at December 31, 2006 from 64.0% at December 31, 2005.

As a by-product of the Bank's emphasis on checking account growth, as well as deposit fee enhancement programs, service charges on deposit accounts (which include insufficient funds ( NSF ) fees) have grown over the years and represents the largest source of noninterest income for the Company.

Service charges on deposit accounts produced a double-digit percentage increase from the prior year with an increase of \$494,000, or 10.8%, from \$4.6 million for 2005, to \$5.1 million for 2006.

Although the Bank would prefer growth in lower-costing core accounts, during 2006, customers displayed a preference for higher-yielding savings and term deposit accounts. CD balances grew to \$381.7 million at December 31, 2006, compared to \$353.0 million at December 31, 2005, an increase of \$28.7 million, or 8.1%. This increase includes approximately \$30.0 million of brokered CDs at December 31, 2006, whereas the Bank did not have any brokered CDs at the prior-year end.

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 available for sale 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.

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 and as opportunities present themselves. Additionally, the Bank will utilize borrowings as part of the Bank's overall strategy to manage interest rate risk. At December 31, 2006, total borrowings stood at \$337.1 million compared to \$344.8 million at December 31, 2005.

### **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, 2006, 2005 and 2004 were \$872,000, \$849,000 and \$973,000, respectively.

### **Employees**

At December 31, 2006, the Company had 228 full-time and 42 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. Since 2002, changes to 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 two decades 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 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 Bank paid a minimum assessment of \$2,000 in 2006; however, it is possible that the FDIC could impose assessment rates in the future in connection with declines in the insurance funds or increases in the amount of insurance coverage.

An increase in the assessment rate could have a material adverse effect on the Company's earnings, depending on the amount of the increase. Under the Federal Deposit Insurance Reform Act of 2005, which became law in 2006, the Bank received a one-time assessment credit of \$585,000 that can be applied against future premiums, subject to certain limitations.

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, 2006, the Bank's Tier 1 leverage ratio was 7.18%, its total Risk-Based Capital Ratio was 10.32% and its Tier 1 Risk-Based Capital Ratio was 11.54%. Based upon the above ratios, the Bank is considered well capitalized for regulatory capital purposes. Additionally, at December 31, 2006, the Company had approximately \$17 million of additional capital (held at the parent company), which is available to support the Bank's future growth.

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, 2006, on a consolidated basis, the Company's Tier 1 Leverage Ratio was 8.37%, its total Risk-Based Capital Ratio was 12.05% and its Tier 1 Risk-Based Capital Ratio was 13.27%. 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 \$5.4 million at December 31, 2006 and \$5.6 million at December 31, 2005. 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" 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 21<sup>st</sup> 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 two national banking institutions and one large regional banking institution 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 service providers such as mutual fund companies, brokerage firms, insurance companies and credit unions. 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 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 or inversion 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 the fair value of the 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, 2006, 51.8% of our loan and lease portfolio consisted of commercial real estate, business and construction loans and leases, an increase from 46.1% of our loan and lease portfolio at December 31, 2005. 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, business and economic conditions, the character and size of the portfolio, loan growth, 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, 2006, the allowance for loan and lease losses totaled \$12.4 million, representing 1.23% 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 and an attractive mix of deposits 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, the yield curve has been flat-to-inverted during the past two years. Also, customers in the past few years have indicated a preference for higher-yielding term deposit and savings account products. Similarly, our lower-costing core deposits have increased at a more moderate rate. We cannot predict whether this increased demand for higher rate products is permanent or will abate. 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 our common stock is currently traded on the Nasdaq Stock Market's Global Select Markets<sup>SM</sup>, 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.

*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 22.8% of our outstanding common stock as of December 31, 2006. 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**

None.

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**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
<i>Branch offices:</i>				
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	10/31/08
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.
<i>Administrative and operational offices:</i>				
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
<i>Planned branch offices:</i>				
90 Point Judith Road, Narragansett, RI	(A)	N.A.	Leased	3/31/27
499 Smithfield Avenue, Pawtucket, RI.	(A)	N.A.	Leased	5/31/21

(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 2006.

**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 Global Select Market<sup>SM</sup> under the symbol **BARI**. The following table sets forth certain information regarding our common stock for the periods indicated.

	<b>Stock Price High</b>	<b>Low</b>	<b>Dividend Paid</b>
<b>2005:</b>			
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
<b>2006:</b>			
First Quarter	\$ 35.65	\$ 32.75	\$ 0.15
Second Quarter	39.94	33.31	0.15
Third Quarter	45.40	38.91	0.15
Fourth Quarter	45.37	42.09	0.15

As of February 28, 2007, there were approximately 1,700 holders of record of our common stock.

The following graph and table show changes in the value of \$100 invested on December 31, 2001 through December 31, 2006, in our common stock, the Russell 3000, and the SNL Financial L.C. New England Bank Index. The investment values are based on share price appreciation plus dividends paid in cash, assuming that dividends were reinvested on the date they were paid.

**Total Return Performance**

<b>Index</b>	<b>Period Ending</b>					
	<b>12/31/01</b>	<b>12/31/02</b>	<b>12/31/03</b>	<b>12/31/04</b>	<b>12/31/05</b>	<b>12/31/06</b>
Bancorp Rhode Island, Inc.	100.00	134.74	198.56	242.99	207.50	273.86
Russell 3000	100.00	78.46	102.83	115.11	122.16	141.35
SNL New England Bank Index	100.00	75.43	124.46	131.63	131.49	155.20



## ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following table represents selected consolidated financial data as of and for the years ended December 31, 2006, 2005, 2004, 2003 and 2002. 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,				
	2006	2005	2004	2003	2002
	(Dollars in thousands, except per share data)				
Statements of operations data:					
Interest income	\$ 81,202	\$ 69,520	\$ 57,719	\$ 51,773	\$ 53,507
Interest expense	38,974	26,619	19,625	19,453	22,180
Net interest income	42,228	42,901	38,094	32,320	31,327
Provision for loan and lease losses	1,202	1,423	836	1,524	1,808
Noninterest income	8,988	9,274	8,581	8,830	7,083
Noninterest expense	38,727	36,343	32,929	28,866	25,091
Income before taxes	11,287	14,409	12,910	10,760	11,511
Income taxes	3,576	4,840	4,296	3,546	3,849
Net income	\$ 7,711	\$ 9,569	\$ 8,614	\$ 7,214	\$ 7,662
Per share data:					
Basic earnings per common share	\$ 1.62	\$ 2.14	\$ 2.17	\$ 1.89	\$ 2.04
Diluted earnings per common share	\$ 1.57	\$ 2.04	\$ 2.04	\$ 1.77	\$ 1.92
Dividends per common share	\$ 0.60	\$ 0.60	\$ 0.58	\$ 0.56	\$ 0.53
Dividend pay-out ratio	38.2	% 29.4	% 28.4	% 31.6	% 27.6
Book value per common share	\$ 23.39	\$ 22.21	\$ 19.68	\$ 18.53	\$ 17.59
Tangible book value per common share	\$ 21.03	\$ 19.83	\$ 16.99	\$ 15.76	\$ 14.73
Average common shares outstanding					
Basic	4,766,854	4,478,081	3,975,413	3,819,232	3,758,214
Diluted	4,920,569	4,697,134	4,222,856	4,085,878	3,996,670
Balance sheet data:					
Total assets	\$ 1,479,099	\$ 1,442,782	\$ 1,239,069	\$ 1,093,971	\$ 1,012,877
Investment securities	103,425	150,959	104,600	98,595	101,329
Mortgage-backed securities	240,462	234,858	159,946	106,618	156,114
Total loans and leases receivable	1,004,292	950,806	886,301	814,282	670,658
Allowance for loan and lease losses	12,377	11,665	11,454	10,690	9,784
Goodwill, net	11,317	11,234	10,766	10,766	10,766
Deposits	1,016,423	980,969	880,674	811,283	761,911
Borrowings	337,097	344,769	271,386	203,622	179,305
Total shareholders' equity	112,085	104,832	78,923	72,107	66,427
Average balance sheet data:					
Total assets	\$ 1,451,959	\$ 1,347,510	\$ 1,168,454	\$ 1,046,741	\$ 947,205
Investment securities	144,460	131,711	102,827	91,153	71,481
Mortgage-backed securities	227,973	209,004	132,946	123,524	177,753
Total loans and leases receivable	980,598	916,273	848,550	747,174	622,545
Allowance for loan and lease losses	12,002	11,560	11,072	10,739	9,375
Goodwill, net	11,290	11,067	10,766	10,766	10,766
Deposits	965,194	928,374	858,739	779,540	706,338
Borrowings	362,721	306,344	227,365	192,068	174,668
Total shareholders' equity	106,874	95,922	74,704	69,010	61,922
Operating ratios:					
Interest rate spread	2.50	% 2.92	% 3.07	% 2.91	% 3.04
Net interest margin	3.06	% 3.35	% 3.44	% 3.28	% 3.48
Efficiency ratio (a)	75.62	% 69.66	% 70.55	% 70.15	% 65.32
Return on average assets	0.53	% 0.71	% 0.74	% 0.69	% 0.81
Return on average equity	7.22	% 9.98	% 11.53	% 10.45	% 12.37
Asset quality ratios:					
Nonperforming loans to total loans	0.14	% 0.04	% 0.08	% 0.30	% 0.11
Nonperforming assets to total assets	0.10	% 0.03	% 0.06	% 0.23	% 0.08
Allowance for loan and lease losses to nonperforming loans	875.94	% 2,810.84	% 1,562.62	% 434.20	% 1,329.35
Allowance for loan and lease losses to total loans	1.23	% 1.23	% 1.29	% 1.31	% 1.46
Net loans charged-off to average loans outstanding	0.05	% 0.13	% 0.01	% 0.08	% 0.05



**As of and for the year ended December 31,**  
**2006      2005      2004      2003      2002**  
**(Dollars in thousands, except per share data)**

Capital ratios:										
Average shareholders' equity to average total assets	7.36	%	7.11	%	6.40	%	6.59	%	6.54	%
Tier I leverage ratio	8.37	%	8.21	%	7.06	%	6.76	%	6.19	%
Tier I risk-based capital ratio	12.05	%	12.62	%	10.01	%	9.71	%	9.63	%
Total risk-based capital ratio	13.27	%	13.87	%	11.26	%	10.92	%	10.88	%

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

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

### Introduction

Bancorp Rhode Island, Inc., a Rhode Island corporation, is the holding company for Bank Rhode Island. 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 business, commercial real estate, consumer and residential loans and leases, deposit products, nondeposit investment products, cash management, private banking 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 another period of growth for the Company. The Company increased its commercial loan and lease portfolio by over 18%. Consumer loans grew 7.6% in 2006, with much of the growth coming in the first half of the year. Demand deposit account growth of 8.2% led the overall total deposit increase of 3.6% in 2006. Also, the Company strengthened its senior management team and reorganized its lending function. 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 yield on interest-earning assets (net interest margin), and the quality of the Company's assets.

The Company's net interest income represents 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. Further, 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. In 2005, the Bank formed a private banking division and completed the Bank's first acquisition with the acquiring of an equipment leasing company located in Long Island, New York (Macrolease). The Bank uses the Macrolease platform to increase its portfolio of equipment leases and 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 2006 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 loans and deposits has remained intense during the past few years. This competition has most recently resulted in an increase in competitors' advertising and promotional product offerings in print and television media, as well as direct mailings.

In 2006, approximately 82.5% of the Company's total revenues (defined as net interest income plus noninterest income) were 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 experienced growth in 2006 in the areas of service charges on deposit accounts and commissions on leases originated for third parties.

During 2006, the Company's focus on core deposit accounts produced a modest increase in core deposits, with the decreases in NOW and money market accounts being offset by gains in demand deposit accounts and savings accounts. However, competitive market forces and rising rates have resulted in upward repricing of savings account products. Additionally, customer demand for higher-yielding CDs remained strong. These factors, along with the prolonged flattening of the yield curve, have contributed to higher costs and compression in the net interest margin. The Bank experienced an overall decrease in net interest margin, as 2006's net interest margin of 3.06% was 29 basis points lower than 2005's net interest margin of 3.35%.

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 credit losses, review of goodwill for impairment and income taxes. There have been no significant changes in the methods or assumptions used in accounting policies that require material estimates or assumptions.

#### *Allowance for credit losses*

Arriving at an appropriate level of allowance for loan and lease losses and reserve for unfunded lending commitments, collectively referred to as the allowance for credit 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, leases and commitments 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. A similar process is employed with respect to unfunded lending commitments.

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 credit 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 has generated \$551,000 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.

#### *Income taxes*

Certain areas of accounting for income taxes require management's judgment, including determining the expected realization of deferred tax assets. Judgments are made regarding various tax positions, which are often subjective and involve assumptions about items that are inherently uncertain. If actual factors and conditions differ materially from estimates made by management, the actual realization of the net deferred tax assets could vary materially from the amounts previously recorded.

Deferred tax assets arise from items that may be used as a tax deduction or credit in future income tax returns, for which a financial statement tax benefit has already been recognized. The realization of the net deferred tax asset generally depends upon future levels of taxable income and the existence of prior years' taxable income to which refund claims could be carried back. Valuation allowances are recorded against those deferred tax assets determined not likely to be realized. Deferred tax liabilities represent items that will require a future tax payment. They generally represent tax expense recognized in our financial statements for which payment has been deferred, or a deduction taken on our tax return but not yet recognized as an expense in our financial statements. Deferred tax liabilities are also recognized for certain non-cash items such as goodwill.

### **Results of Operations**

#### *Net Interest Income*

Net interest income for 2006 was \$42.2 million, compared to \$42.9 million for 2005 and \$38.1 million for 2004. The net interest margin decreased in 2006 to 3.06%, compared to 3.35% in 2005. In 2004, the net interest margin was 3.44%. The decrease in net interest income of \$673,000, or 1.6%, during 2006 was primarily attributable to compression in the net interest margin. Average earning assets increased \$99.6 million, or 7.8%, and average interest-bearing liabilities increased \$87.7 million, or 8.3%, during 2006, compared to 2005.

#### *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

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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 2006			2005			2004		
	Average balance (Dollars in thousands)	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield
<b>Assets</b>									
Earning assets:									
Overnight investments	\$ 9,931	\$ 517	5.21 %	\$ 8,015	\$ 201	2.51 %	\$ 12,286	\$ 138	1.12 %
Investment securities	144,460	6,245	4.32 %	131,711	5,537	4.20 %	102,827	4,452	4.33 %
Mortgage-backed securities	227,973	10,542	4.62 %	209,004	9,313	4.46 %	132,946	5,709	4.29 %
Stock in the FHLB	16,473	906	5.50 %	14,842	647	4.36 %	10,811	308	2.85 %
Loans receivable:									
Commercial loans and leases	473,851	34,381	7.26 %	421,429	28,015	6.65 %	369,263	23,092	6.25 %
Residential mortgage loans	288,374	15,352	5.32 %	307,659	15,670	5.09 %	337,825	17,087	5.06 %
Consumer and other loans	218,373	13,259	6.07 %	187,185	10,137	5.42 %	141,462	6,933	4.90 %
Total earning assets	1,379,435	81,202	5.89 %	1,279,845	69,520	5.43 %	1,107,420	57,719	5.21 %
Cash and due from banks	22,274			25,218			23,170		
Allowance for loan and lease losses	(12,002 )			(11,560 )			(11,072 )		
Premises and equipment	14,840			13,765			12,709		
Goodwill, net	11,290			11,067			10,766		
Accrued interest receivable	5,840			5,174			4,584		
Bank-owned life insurance	20,841			18,452			16,026		
Prepaid expenses and other assets	9,441			5,549			4,851		
Total assets	\$ 1,451,959			\$ 1,347,510			\$ 1,168,454		
<b>Liabilities and Shareholders Equity</b>									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 71,188	356	0.50 %	\$ 94,296	590	0.63 %	\$ 123,064	1,172	0.95 %
Money market accounts	8,757	161	1.84 %	17,577	235	1.34 %	16,315	213	1.31 %
Savings accounts	349,675	7,929	2.27 %	337,756	4,734	1.40 %	325,019	3,899	1.20 %
Certificate of deposit accounts	355,908	14,030	3.94 %	304,572	8,962	2.94 %	225,381	5,638	2.50 %
Overnight and short-term borrowings	44,241	2,124	4.80 %	23,019	652	2.83 %	16,643	157	0.94 %
Wholesale repurchase agreements	20,000	870	4.35 %						