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	**05-0509802**
(State or Other Jurisdiction of Incorporation or Organization)	(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 o No x

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 o No x

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 x No o

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. o

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 o Accelerated filer x Non-accelerated filer o

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

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.

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 early or opt out of this authority prior to such date, (iii) banks to establish new branches on an interstate basis provided that such action is specifically authorized by the law of the host state, (iv) foreign banks to establish, with approval of the appropriate regulators in the United States, branches outside their home states to the same extent that national or state banks located in such state would be authorized to do so and (v) banks to receive deposits, renew time deposits, close loans and receive payments on loans and other obligations as agent for any bank or thrift affiliate, whether the affiliate is located in the same or different state. Rhode Island adopted opt in legislation, which permits full interstate banking acquisition and branching.

Gramm-Leach-Bliley Act

In late 1999, Congress enacted the Gramm-Leach-Bliley Act (the G-L-B Act), which repealed provisions of the 1933 Glass-Steagall Act that required separation of the commercial and investment banking industries.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

Under the G-L-B Act and its implementing regulations, financial holding companies may engage in any activity that (i) is financial in nature or incidental to a financial activity under the G-L-B Act or (ii) is complementary to a financial activity and does not impose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The G-L-B Act and its accompanying regulations specify certain activities that are financial in nature such as acting as principal, agent or broker for insurance; underwriting, dealing in or making a market in securities; and providing financial and

investment advice. The new financial activities authorized by the G-L-B Act may also be engaged in by a financial subsidiary of a national or state bank, except for insurance or annuity underwriting, insurance company portfolio investments, real estate investments and development and merchant banking, which must be conducted in a financial holding company. The FRB and the Secretary of the Treasury have the authority to decide whether other activities are also financial in nature or incidental thereto, taking into account changes in technology, changes in the banking marketplace, competition for banking services and other pertinent factors. Although the Company may meet the qualifications to become a financial holding company, it has no current plans to elect such status.

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

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

Other Aspects of Federal and State Laws

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

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

Sarbanes-Oxley Act of 2002 *In* July 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) which imposed significant additional requirements and restrictions on publicly-held companies, such as the Company. These provisions include requirements governing the independence, composition and responsibilities of audit committees, financial disclosures and reporting and restrictions on personal loans to directors and officers. Sarbanes-Oxley, among other things, mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and speedier transaction reporting requirements for executive officers, directors and 10% shareholders. Rules promulgated by the SEC pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to enhance their independence

from management. In addition, penalties for non-compliance with the Exchange Act are heightened. The Company has not experienced any significant difficulties in complying with this legislation. However, the Company has incurred, and expects to continue to incur, costs in connection with its compliance with Section 404 of Sarbanes-Oxley which requires management to undertake an assessment of the adequacy and effectiveness of the Company s internal controls over financial reporting and requires the Company s auditors to attest to, and report on, management s assessment and the operating effectiveness of these controls.

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

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

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

Effect of Governmental Policy

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

ITEM 1A. RISK FACTORS

Overview

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

Risks Related to Our Business

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

We face significant competition from a variety of traditional and nontraditional financial service providers both within and outside of Rhode Island, both in making loans and generating deposits. Our most significant competition comes from 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 MarketSM, 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.

ITEM 2. PROPERTIES

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

The following are the locations of the Bank s offices:

Location	Size (Square feet)	Year Opened or Acquired	Owned or Leased	Lease Expiration Date
Branch offices:				
1047 Park Avenue, Cranston, RI.	4,700	1996	Owned	N.A.
383 Atwood Avenue, Cranston, RI.	4,700	1996	Owned	N.A.
2104 Plainfield Pike, Cranston, RI.	700	2002	Owned	N.A.
1269 South County Trail, East Greenwich, RI.	2,600	2005	Leased	5/31/25
999 South Broadway, East Providence, RI.	3,200	1996	Leased	11/30/12
195 Taunton Avenue, East Providence, RI.	3,100	1996	Leased	2/28/08
1440 Hartford Avenue, Johnston, RI.	4,700	1996	Land Leased	12/31/07
625 G. Washington Highway, Lincoln, RI.	1,000	2005	Leased	12/31/12
Ten Rod Road, North Kingstown, RI.	4,000	2004	Land Leased	6/30/19
One Turks Head Place, Providence, RI.	5,000	1996	Leased	4/30/09
165 Pitman Street, Providence, RI.	3,300	1998	Leased	10/31/08
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.
Administrative and operational offices:				
625 G. Washington Highway, Lincoln, RI.	23,600	2003	Leased	12/31/12
One Turks Head Place, Providence, RI.	20,600	1999	Leased	6/30/09
One Ames Court, Plainview, NY	4,400	2005	Leased	1/31/08
Planned branch offices:				
90 Point Judith Road, Narragansett, RI	(A)	N.A.	Leased	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 MarketSM under the symbol BARI . The following table sets forth certain information regarding our common stock for the periods indicated.

	Stock Price High	Low	Dividend Paid
2005:			
First Quarter	$ 40.00	$ 35.96	$ 0.15
Second Quarter	38.07	35.39	0.15
Third Quarter	37.45	35.11	0.15
Fourth Quarter	36.55	33.29	0.15
2006:			
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

Index	Period Ending 12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
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
Average common shares outstanding					
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 %

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	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

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	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield	Average balance	Interest earned/ paid	Average yield
	(Dollars in thousands)								
Assets									
Earning assets:									
Overnight investments	$ 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		
Liabilities and Shareholders Equity									
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 %	9,417	276	2.93 %			0.00 %
FHLB borrowings	279,922	12,044	4.30 %	255,350	9,898	3.88 %	193,234	7,505	3.88 %
Subordinated deferrable interest debentures	18,558	1,460	7.87 %	18,558	1,272	6.85 %	17,487	1,041	5.95 %
Total interest-bearing liabilities	1,148,249	38,974	3.39 %	1,060,545	26,619	2.51 %	917,143	19,625	2.14 %
Noninterest-bearing deposits	179,666			174,173			168,960		
Other liabilities	17,170			16,870			7,647		
Total liabilities	1,345,085			1,251,588			1,093,750		
Shareholders equity	106,874			95,922			74,704		
Total liabilities and shareholders equity	$ 1,451,959			$ 1,347,510			$ 1,168,454		
Net interest income		$ 42,228			$ 42,901			$ 38,094	
Net interest rate spread			2.50 %			2.92 %			3.07 %
Net interest rate margin			3.06 %			3.35 %			3.44 %

Rate/Volume Analysis

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

	Year ended December 31, 2006 vs. 2005 Increase/ (decrease) due to			**2005 vs. 2004 Increase/(decrease) due to**		
	Rate	**Volume**	**Total**	**Rate**	**Volume**	**Total**
	(In thousands)					
Interest income:						
Overnight investments	$ 258	$ 58	$ 316	$ 124	$ (61)	$ 63
Investment securities	239	469	708	(132)	1,217	1,085
Mortgage-backed securities	418	811	1,229	223	3,381	3,604
Stock in the FHLB	182	77	259	199	140	339
Commercial loans and leases	2,204	4,162	6,366	1,519	3,404	4,923
Residential mortgage loans	693	(1,011)	(318)	118	(1,535)	(1,417)
Consumer and other loans	1,368	1,754	3,122	786	2,418	3,204
Total interest income	5,362	6,320	11,682	2,837	8,964	11,801
Interest expense:						
NOW accounts	(105)	(129)	(234)	(346)	(236)	(582)
Money market accounts	69	(143)	(74)	5	17	22
Savings accounts	3,022	173	3,195	677	158	835
Certificate of deposit accounts	3,387	1,681	5,068	1,111	2,213	3,324
Overnight & short-term borrowings	632	840	1,472	416	79	495
FHLB and other borrowings	1,736	1,004	2,740	(81)	2,750	2,669
Capital trust and other subordinated securities	188		188	164	67	231
Total interest expense	8,929	3,426	12,355	1,946	5,048	6,994
Net interest income	$ (3,567)	$ 2,894	$ (673)	$ 891	$ 3,916	$ 4,807

Comparison of Years Ended December 31, 2006 and December 31, 2005

General

Net income for 2006 decreased $1.9 million, or 19.4%, from $9.6 million for 2005. Earnings per diluted common share (EPS) decreased also from $2.04 for 2005 to $1.57 for 2006. The 2006 earnings represented a return on average assets of 0.53% and a return on average equity of 7.22% for 2006, as compared to a return on average assets of 0.71% and a return on average equity of 9.98% for 2005.

Net income and EPS for 2006 were negatively impacted by approximately $558,000 or $0.11, net of taxes, due to the investment portfolio restructuring the Company undertook in the third quarter of 2006 in an effort to improve earnings in future periods. 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.

To provide additional analysis regarding the Company s operating results, the following tables set forth certain information relating to the reconciliation of GAAP net income, EPS and related operating

ratios to pro forma amounts, which adjust for securities gains and losses over the past two years. Management believes this information is useful to the investor in comparing the Company s operating results to the prior year.

	Year ended December 31, 2006	2005
	(In thousands, except per share data)	
Net income (GAAP)	$ 7,711	$ 9,569
Adjust for:		
Securities losses (gains), net of tax	558	(118)
Pro forma net income	$ 8,269	$ 9,451
Diluted earnings per share (GAAP)	$ 1.57	$ 2.04
Effect of:		
Securities losses (gains), net of tax	0.11	(0.03)
Pro forma diluted earnings per share	$ 1.68	$ 2.01

	Year Ended December 31, 2006 Return on Average Assets	Return on Average Equity	Efficiency Ratio
GAAP ratios	0.53 %	7.22 %	75.62 %
Effect of:			
Security losses (gains), net of tax	0.04 %	0.52 %	-1.25 %
Pro forma ratios	0.57 %	7.74 %	74.37 %

	Year Ended December 31, 2005 Return on Average Assets	Return on Average Equity	Efficiency Ratio
GAAP ratios	0.71 %	9.98 %	69.66 %
Effect of:			
Security losses (gains), net of tax	-0.01 %	-0.12 %	0.24 %
Pro forma ratios	0.70 %	9.86 %	69.90 %

On a pro forma basis, operating results for 2006 were down as compared to 2005. Margin compression led to a decline in net interest income of $673,000, despite an increase in total average earning assets of approximately $100 million. The increases in noninterest income of $754,000, led primarily by increases in deposit service charges and commissions on originations of loans and leases, were offset by increased noninterest expenses. In addition to the aforementioned additions to the senior management team, the noninterest expenses for 2006 include the full year operating costs of Macrolease, the private banking group and the two newest branches, all of which began midway through 2005.

Net Interest Income

For 2006, net interest income was $42.2 million, compared to $42.9 million for 2005. The net interest margin for 2006 was 3.06% compared to a net interest margin of 3.35% for 2005. The decrease in net interest income of $673,000, or 1.6%, was attributable to margin pressures as the average earning assets increased $99.6 million, or 7.8%, and average interest-bearing liabilities increased $87.7 million, or 8.3%, over the preceding year. The decrease of 29 basis points in the net interest margin was due to the compression of the yield curve, competitive asset pricing, increases in CD balances and heightened competition for savings and other core deposits in the Company s market area.

Interest Income Investments

Total investment income (consisting of interest on overnight investments, investment securities and MBSs, and dividends on FHLB stock) was $18.2 million for 2006, compared to $15.7 million for 2005. This increase in total investment income of $2.5 million, or 16.0%, was attributable to a 25 basis point increase in the overall yield on investments, from 4.32% in 2005 to 4.57% in 2006, along with an increase in the average balance of investments of approximately $35 million.

Interest Income Loans and Leases

Interest from loans was $63.0 million for 2006, and represented a yield on total loans of 6.42%. This compares to $53.8 million of interest, and a yield of 5.87%, for 2005. Increased interest income resulting from growth in the average balance of loans of $64.3 million, or 7.0%, was augmented by an increase in the yield on loans of 55 basis points.

The average balance of the various components of the loan portfolio changed as follows: commercial loans and leases increased $52.4 million, or 12.4%; consumer and other loans increased $31.2 million, or 16.7%; and residential mortgage loans decreased $19.3 million, or 6.3%. The yield on the various components of the loan portfolio changed as follows: commercial loans and leases increased 61 basis points, to 7.26%; consumer and other loans increased 66 basis points, to 6.07%; and residential mortgage loans increased 23 basis points, to 5.32%. The yields on loans and leases benefited primarily from the interest rate increases in 2006.

Interest Expense Deposits and Borrowings

Interest paid on deposits and borrowings increased by $12.4 million, or 46.4%, due to both market area competition as well as rises in short-term market interest rates during 2006. The overall average cost for interest-bearing liabilities increased 88 basis points from 2.51% for 2005, to 3.39% for 2006. The average balance of total interest-bearing liabilities increased $87.7 million, or 8.3%, from $1.06 billion in 2005, to $1.15 billion in 2006. The growth in deposit average balances was centered primarily in CD accounts (up $51.4 million, or 16.9%) and savings accounts (up $11.9 million, or 3.5%). These increases were partially offset by a decrease in NOW accounts (down $23.1 million, or 24.5%) and money market accounts (down $8.8 million, or 50.2%).

In addition, the average balance of borrowings increased as compared to the prior year, as the Bank utilized short-term borrowings (up $21.2 million, or 92.2%), FHLB funding (up $24.6 million, or 9.6%) and wholesale repurchase agreements (up $10.6 million, or 112.4%) to fund a portion of the new asset growth. The balance of wholesale repos has remained constant at $20 million since midway through the fourth quarter of 2005. Overall, the cost of nondeposit borrowings increased 60 basis points in 2006 to 4.55%, compared to 3.95% in the prior year.

The rise in liability costs can be attributed to a number of factors. With the rises in interest rates during 2006, customer demand for higher-yielding deposit products has strengthened. Additionally, competition for deposits has become intense and extensive bank advertising has increased customer awareness of attractive rates. Moreover, online banking has enabled customers to more actively manage their finances and has facilitated the movement of available funds from demand deposit accounts and normally lower-costing deposit accounts into higher-yielding deposit products. In an effort to attract and retain customers and deposit relationships, the Bank has offered not only the typically higher-costing CDs, but also higher-yielding savings and NOW accounts.

Provision for Loan and Lease Losses

The provision for loan and lease losses was $1.2 million for 2006, compared to $1.4 million for 2005. The allowance, expressed as a percentage of total loans and leases, was 1.23% as of December 31, 2006, compared to 1.23% at the prior year-end and stood at 876.0% of nonperforming loans and leases at December 31, 2006, compared to 2810.8% of nonperforming loans and leases at December 31, 2005. Net charge-offs for 2006 were $490,000, compared to $1.2 million for 2005.

In 2006, the Company reclassified the reserve for unfunded lending commitments (December 31, 2005 year-end balance of $503,000) from the allowance for loan and lease losses to other liabilities. The Company has reclassified prior period amounts accordingly, as illustrated within the activity analysis table on page 47. These reclassifications resulted in adjustments to the prior period ending and average balances of the allowance for loan and lease losses and other liabilities, the allocation of the allowance for loan and lease losses, as well as previously reported expense amounts for the provision for loan and lease losses and other expenses and related asset quality ratios. Also see discussion under *Allowance for Credit Losses*.

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

Noninterest Income

Total noninterest income decreased by $286,000, or 3.1%, from $9.3 million for 2005, to $9.0 million for 2006. The following table sets forth the components of noninterest income:

	Year ended December 31,	
	2006	**2005**
	(In thousands)	
Service charges on deposit accounts	$ 5,055	$ 4,561
Commissions on nondeposit investment products	872	849
Income from bank-owned life insurance	785	691
Loan related fees	694	1,024
Commissions on loans originated for others	159	184
(Loss)/gain on available for sale securities	(859)	181
Other income	2,282	1,784
Total noninterest income	$ 8,988	$ 9,274

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 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 investment income of over $900,000 by the end of 2007.

Excluding securities gains and losses, noninterest income increased $754,000, or 8.3%. Deposit account service charges continue to represent the largest source of noninterest income for the Company and produced the highest growth within the category with an increase of $494,000, or 10.8%, to $5.1 million for 2006, compared to $4.6 million in the prior year. Income from bank-owned life insurance

(BOLI) increased $94,000, or 13.6% from the prior year as a result of additional purchases of insurance throughout the year. The Company also conducted a tax-free exchange of a portion of its BOLI to other life insurance carriers in the fourth quarter of 2006, which should increase income from BOLI in future years. In addition, the Company experienced a moderate increase in commissions on nondeposit investment products of $23,000, or 2.7%. Other income increased by $498,000, or 27.9%, with increases in customer related sweep activity and commissions from leases originated for third parties. These increases in noninterest income were partially offset by a decline in commissions on loans originated for others of $25,000, or 13.6% and a decrease in loan related fees of $330,000, or 32.2%. Loan related fees in 2005 were higher primarily as a result of increased prepayment activity in 2005.

Noninterest Expense

Noninterest expenses for 2006 increased a total of $2.4 million, or 6.6%, to $38.7 million. The following table sets forth the components of noninterest expense:

	Year ended December 31,	
	2006	**2005**
	(In thousands)	
Salaries and employee benefits	$ 20,636	$ 19,476
Occupancy and equipment	4,971	4,695
Data processing	2,880	2,759
Professional services	2,186	2,017
Marketing	1,880	1,584
Loan servicing	917	968
Loan workout and other real estate owned	188	217
Other expenses	5,069	4,627
Total noninterest expense	$ 38,727	$ 36,343

Overall, noninterest expenses reflected the continued growth of the Company resulting in higher operating costs. Such growth includes the Bank opening two new branches in Lincoln and East Greenwich, Rhode Island and the addition of Macrolease and One Trust & Private Banking (all occurring during the second quarter of 2005). Also, additions were made to the Company s business ranks over the past year. The increases in costs were centered in the following areas: salaries and benefits (up $1.2 million, or 6.0%) and occupancy and equipment costs (up $276,000, or 5.9%).

Marketing costs were up by $296,000, or 18.7%, reflective of increased advertising spending and sponsorship of customer events. Additionally, professional services costs increased $169,000, or 8.4%, partially as a result of increased investor relations costs. Also, data processing costs increased $121,000, or 4.4%. Other expenses increased by $442,000, or 9.6%, as compared to 2005, with increases in costs of customer related sweep activity, which were in line with the related increase in noninterest income.

Other expenses for 2006 also includes $89,000 related to director stock options, the fair value of which was required to be expensed in connection with the adoption of SFAS 123-R, *Share-Based Payment* . In 2005, the Company was not required to recognize expenses for the estimated fair value of stock options as the Company accounted for stock options under SFAS 123, *Accounting for Stock-Based Compensation* . Under SFAS 123, the Company utilized the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and did not recognize expenses for the granting of stock options. Including stock option costs for employee grants, stock option expenses for 2006 were $186,000 compared to $49,000 for 2005. The costs recorded in 2005 related exclusively to the December 2005 acceleration of vesting of then-outstanding stock options.

Additionally, in December 2006, the Company recorded insurance recovery proceeds of $803,000 relating to a loss the Company incurred in the first quarter of 2006 of $868,000. These amounts are

recorded net within other expenses in the preceding table and on the Consolidated Statement of Operations for the year ended December 31, 2006.

Overall, the Company s efficiency ratio increased to 75.62% for 2006, from 69.66% for 2005; however, after adjusting for securities gains and losses, the pro forma efficiency ratios were 74.37% and 69.90%, respectively.

Income Tax Expense

The Company recorded income tax expense of $3.6 million for 2006, compared to $4.8 million for 2005. This represented total effective tax rates of 31.7% and 33.6%, respectively. Tax-favored income from BOLI, along with the utilization of a Rhode Island passive investment company, has reduced the Company s effective tax rate from the 40.9% combined statutory federal and state tax rates.

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

General

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

Net Interest Income

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

Interest Income Investments

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

Interest Income Loans and Leases

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

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

Interest Expense   Deposits and Borrowings

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

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

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

Provision for Loan and Lease Losses

The provision for loan and lease losses was $1.4 million for 2005, compared to $836,000 for 2004. The allowance, expressed as a percentage of total loans and leases, was 1.23% as of December 31, 2005, compared to 1.29% at the prior year-end and stood at 2810.8% of nonperforming loans and leases at December 31, 2005, compared to 1562.63% of nonperforming loans and leases at December 31, 2004. Net charge-offs for 2005 were $1.2 million, compared to $72,000 for 2004. The increase in net charge-offs occurred largely during the second quarter and was attributable to one asset-based credit. To resolve the credit, the Bank sold the loan to a third party at a discount, resulting in a $1.2 million charge-off.

During 2006, the Company reclassified the reserve for unfunded lending commitments from the allowance for loan and lease losses to other liabilities. The Company has reclassified prior period amounts accordingly as previously discussed on page 33 and as illustrated within the activity analysis table on page 47.

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

Noninterest Income

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

The following table sets forth the components of noninterest income:

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

Noninterest Expense

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

The following table sets forth the components of noninterest expense:

	Year ended December 31, 2005	2004
	(In thousands)	
Salaries and employee benefits	$ 19,476	$ 17,072
Occupancy and equipment	4,695	4,260
Data processing	2,759	2,832
Professional services	2,017	1,965
Marketing	1,584	1,429
Loan servicing	968	1,092
Loan workout and other real estate owned	217	110
Other expenses	4,627	4,169
Total noninterest expense	$ 36,343	$ 32,929

Income Tax Expense

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

Financial Condition

Loans and Leases Receivable

Total loans and leases were $1.0 billion, or 67.9% of total assets, at December 31, 2006, compared to $950.8 million, or 65.9% of total assets, at December 31, 2005, an increase of $53.5 million, or 5.6%. This increase is centered in commercial and consumer loans (where the Company concentrates its origination efforts) and was partially offset by a decrease in residential mortgage loans (which the Company primarily purchases). Total loans and leases as of December 31, 2006 are segmented in three broad categories: commercial loans and leases that aggregate $519.8 million, or 51.8% of the portfolio; residential mortgages that aggregate $263.9 million, or 26.2% of the portfolio; and consumer and other loans that aggregate $220.6 million, or 22.0% of the portfolio.

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

The following is a summary of loans and leases receivable:

	December 31, 2006 (In thousands)	2005	2004	2003	2002
Commercial loans and leases:					
Commercial real estate owner occupied	$ 140,812	$ 112,987	$ 93,027	$ 77,317	$ 59,249
Commercial real estate nonowner occupied	102,390	95,779	90,716	78,083	81,242
Commercial & industrial	106,017	73,620	78,918	67,925	57,389
Small business	41,785	38,641	37,820	30,429	28,750
Multi-family	34,294	33,725	32,415	28,730	18,952
Construction	37,237	37,772	32,319	30,632	18,101
Leases and other	62,979	48,745	38,116	19,548	17,613
Subtotal	525,514	441,269	403,331	332,664	281,296
Unearned lease income	(6,651)	(3,366)	(226)		
Net deferred loan origination costs (fees)	927	406	(335)	(398)	(329)
Total commercial loans and leases	519,790	438,309	402,770	332,266	280,967
Residential mortgage loans:					
One- to four-family adjustable rate	165,140	202,223	199,031	232,543	277,265
One- to four-family fixed rate	96,880	101,598	115,350	131,743	19,310
Subtotal	262,020	303,821	314,381	364,286	296,575
Premium on loans acquired	1,979	2,257	1,826	2,026	1,248
Net deferred loan origination fees	(54)	(62)	(72)	(82)	(60)
Total residential mortgage loans	263,945	306,016	316,135	366,230	297,763
Consumer and other loans:					
Home equity term loans	152,484	134,932	110,542	68,523	47,906
Home equity lines of credit	64,208	67,959	53,551	42,067	37,381
Automobile	178	157	488	1,455	3,409
Installment	506	365	491	662	967
Savings secured	587	358	439	631	602
Unsecured and other	1,088	1,271	801	1,787	1,063
Subtotal	219,051	205,042	166,312	115,125	91,328
Premium on loans acquired		2	15	44	103
Net deferred loan origination costs	1,506	1,437	1,069	617	497
Total consumer and other loans	220,557	206,481	167,396	115,786	91,928
Total loans and leases receivable	$ 1,004,292	$ 950,806	$ 886,301	$ 814,282	$ 670,658

Commercial loans and leases *During* 2006, the commercial loan and lease portfolio (consisting of commercial real estate, commercial & industrial, equipment leases, multi-family real estate, construction and small business loans) increased $81.5 million, or 18.6%. The primary drivers of this growth occurred in the commercial real estate, commercial & industrial and equipment leasing areas.

The Bank is also active in small business lending in which it utilizes credit scoring, in conjunction with traditional review standards, and employs streamlined documentation. Small business loans represented 8.0% of the commercial loan and lease portfolio at December 31, 2006. The Bank is a participant in the U.S Small Business Administration (SBA) Preferred Lender Program in both Rhode Island and Massachusetts. SBA guaranteed loans are found throughout the portfolios managed by the Bank s various lending groups.

With the addition of Macrolease, the Bank originates equipment leases for its own portfolio, as well as originating leases for third parties as a new source of noninterest income. In addition, the Bank historically has purchased equipment leases from originators outside of the Bank. The principal lessees were the U.S. Government and its agencies for the vast majority of leases. These government leases generally have maturities of five years or less and are not dependent on residual collateral values. 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.

The Company believes it is well positioned for continued commercial growth. Particular emphasis is placed on generation of small- to medium-sized commercial relationships (those relationships with $10.0 million or less in total loan commitments). Unlike most community banks, the Bank is able to offer asset-based commercial loan facilities that monitor advances against receivables and inventories on a formula basis.

Additionally, in the latter part of 2006, the Bank reorganized its business lending function. The business lending group now concentrates its efforts on relationships in excess of $1 million. Business lending relationships of up to $1 million now can be 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 has been moved to the newly created LSU. Management believes this reorganization will enable the Bank to expand its ability to reach more borrowers with the same number of personnel as well as achieve more efficient processing and improved monitoring of these credits.

Residential mortgage loans *Residential* mortgage loans decreased $42.1 million, or 13.8%, as repayments ($48.8 million) exceeded the total of purchases ($5.6 million) and originations ($1.5 million). Since inception, the Bank has concentrated its portfolio lending efforts on commercial and consumer lending opportunities, but originates mortgage loans for its own portfolio on a limited basis. The Bank does not employ any outside mortgage originators, but from time to time, purchases residential mortgage loans from third-party originators. Until such time as the Bank can originate sufficient commercial and consumer loans to utilize available cash flow, it intends to continue purchasing residential mortgage loans as opportunities develop.

Consumer loans *During* 2006, consumer loan outstandings increased $14.1 million, or 6.8%, to $220.6 million at December 31, 2006, from $206.5 million at December 31, 2005. This growth primarily occurred in the first half of the year, with the decline in growth corresponding to the moderate softening of local market area housing prices in the second half of the year. However, the Company believes that these ten- to twenty-year fixed-rate products, along with the floating lines of credit, still possess attractive cash flow characteristics in the current interest rate environment. Over time, the Company anticipates growth in these products will continue.

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

	Year ended December 31, 2006	2005	2004	2003	2002
	(In thousands)				
Originations and principal additions:					
Loans and leases purchased:					
Commercial loans and leases	$ 11,454	$ 9,243	$ 3,257	$	$
Residential mortgage loans	5,644	56,512	55,273	249,656	166,935
Total loans and leases purchased	17,098	65,755	58,530	249,656	166,935
Loans and leases originated:					
Commercial loans and leases	146,802	99,490	109,560	106,335	84,132
Residential mortgage loans	1,450	5,009	9,635	28,371	9,345
Consumer and other loans	64,715	82,426	90,655	65,831	51,951
Total loans and leases originated	212,967	186,925	209,850	200,537	145,428
Principal reductions:					
Net charge-offs/transfers to OREO:					
Commercial loans and leases	(453)	(1,205)	(98)	(565)	(400)
Residential mortgage loans					(58)
Consumer and other loans	(37)	(7)	(51)	(64)	(93)
Total net charge-offs/transfers to OREO	(490)	(1,212)	(149)	(629)	(551)
Principal payments:					
Commercial loans and leases	(78,024)	(72,736)	(42,052)	(54,402)	(41,971)
Residential mortgage loans	(48,763)	(71,249)	(114,813)	(210,316)	(188,542)
Consumer and other loans	(50,205)	(42,978)	(39,417)	(41,970)	(21,304)
Total principal payments	(176,992)	(186,963)	(196,282)	(306,688)	(251,817)
Change in total loans and leases receivable (before net items)	$ 52,583	$ 64,505	$ 71,949	$ 142,876	$ 59,995

The following table sets forth certain information at December 31, 2006, regarding the aggregate dollar amount of certain loans maturing in the loan portfolio based on scheduled payments to maturity. Actual loan principal payments may vary from this schedule due to refinancings, modifications and other changes in loan terms. Demand loans and loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less.

	One year or less	After one, but within five years	After five years
	(In thousands)		
Construction/permanent loans	$ 11,005	$ 17,896	$ 8,336
Commercial & industrial loans (including leases)	42,069	81,383	39,207
Home equity lines of credit	28	49	64,131
Interest-only residential first mortgages			25,769
Small business loans	17,445	14,478	9,862
Total	$ 70,547	$ 113,806	$ 147,305

The following table sets forth as of December 31, 2006, the dollar amount of certain loans due after one year that have fixed interest rates or floating or adjustable interest rates.

	Loans due after one year	
	Fixed rates	Floating or adjustable rates
	(In thousands)	
Construction/permanent loans	$ 6,102	$ 20,130
Commercial & industrial loans (including leases)	81,584	39,006
Home equity lines of credit		64,180
Interest-only residential first mortgages	4,841	20,928
Small business loans	10,773	13,567
Total	$ 103,300	$ 157,811

Asset Quality

The definition of nonperforming assets includes nonperforming loans and other real estate owned (OREO). OREO consists of real estate acquired through foreclosure proceedings and real estate acquired through acceptance of a deed in lieu of foreclosure. Nonperforming loans are defined as nonaccrual loans, loans past due 90 days or more but still accruing and impaired loans. Under certain circumstances, the Company may restructure the terms of a loan as a concession to a borrower. These restructured loans are considered impaired loans. There were no impaired loans included in nonaccrual loans at December 31, 2006, compared to $141,000 and $671,000 of impaired loans at December 31, 2005 and 2004, respectively.

Nonperforming Assets *At* December 31, 2006, the Company had nonperforming assets of $1.4 million, or 0.10%, of total assets. This compares to nonperforming assets of $415,000 or 0.03% of total assets, at December 31, 2005, and nonperforming assets of $733,000, or 0.06% of total assets, at December 31, 2004. Nonperforming assets at December 31, 2006, consisted of residential loans aggregating $1.3 million and commercial loans aggregating $80,000. Nonperforming assets at December 31, 2005 and 2004 were primarily comprised of nonaccrual commercial loans and nonaccrual residential loans. The Company evaluates the underlying collateral of each nonperforming asset and continues to pursue the collection of interest and principal. Management believes that the December 31, 2006 level of nonperforming assets is low relative to the size of the Company s loan portfolio. As the loan portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of nonperforming assets will increase, as will its level of charged-off loans.

The following table sets forth information regarding nonperforming assets.

	December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Nonaccrual loans	$ 1,407	$ 415	$ 733	$ 2,462	$ 736
Loans past due 90 days or more, but still accruing	6				
Impaired loans (not included in nonaccrual loans)					
Total nonperforming loans	1,413	415	733	2,462	736
Other nonperforming assets					58
Total nonperforming assets	$ 1,413	$ 415	$ 733	$ 2,462	$ 794
Nonperforming loans as a percent of total loans and leases	0.14 %	0.04 %	0.08 %	0.30 %	0.11 %
Nonperforming assets as a percent of total assets	0.10 %	0.03 %	0.06 %	0.23 %	0.08 %

Nonaccrual Loans *Accrual* **of interest income on all loans is discontinued when concern exists as to the collectibility of principal or interest, or typically when a loan becomes over 90 days delinquent. Additionally, when a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period income. Residential mortgage loans are removed from nonaccrual when they become less than 90 days past due, and in the case of commercial and consumer loans, when concern no longer exists as to the collectibility of principal or interest. Interest collected on nonaccruing loans is either applied against principal or reported as income according to management s judgment as to the collectibility of principal. At December 31, 2006, nonaccrual loans totaled $1.4 million. Interest on nonaccrual loans that would have been recorded as additional income for the year ended December 31, 2006, had the loans been current in accordance with their original terms, totaled $50,000. This compares with $23,000 and $29,000 of foregone interest income on nonaccrual loans for the years ended December 31, 2005 and 2004, respectively.**

The following table sets forth certain information regarding nonaccrual loans.

	2006		2005		2004	
	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans
	(Dollars in thousands)					
Nonaccrual loans:						
Residential mortgage loans	$ 1,327	0.13 %	$ 119	0.01 %	$ 24	0.00 %
Commercial loans and leases	80	0.01 %	235	0.02 %	709	0.08 %
Consumer and other loans		0.00 %	61	0.01 %		0.00 %
Total nonaccrual loans	$ 1,407	0.14 %	$ 415	0.04 %	$ 733	0.08 %

Delinquencies *At* December 31, 2006, $5.9 million of loans were 30 to 89 days past due. This compares to $5.3 million and $4.9 million of loans 30 to 89 days past due as of December 31, 2005 and 2004, respectively. The majority of these loans at December 31, 2006, 2005 and 2004 were commercial loans and leases.

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

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

	2006		2005		2004	
	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans
	(Dollars in thousands)					
Loans delinquent for 30 to 59 days:						
Commercial loans and leases	$ 4,671	0.47 %	$ 4,509	0.48 %	$ 3,370	0.38 %
Residential mortgage loans	486	0.05 %	399	0.04 %	951	0.11 %
Consumer and other loans	243	0.02 %	139	0.01 %	549	0.06 %
Total loans delinquent 30 to 59 days	5,400	0.54 %	5,047	0.53 %	4,870	0.55 %
Loans delinquent for 60 to 89 days:						
Commercial loans	476	0.05 %				
Residential mortgage loans			300	0.03 %		
Consumer and other loans						
Total loans delinquent 60 to 89 days	476	0.05 %	300	0.03 %		
Total loans delinquent 30 to 89 days	$ 5,876	0.59 %	$ 5,347	0.56 %	$ 4,870	0.55 %

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

At December 31, 2006, the Company had $8.2 million of assets that were classified as substandard. This compares to $6.8 million and $5.8 million of assets that were classified as substandard at December 31, 2005 and 2004, respectively. The Company had no assets that were classified as loss or doubtful at any of these dates. Performing loans may or may not be adversely classified depending upon management s judgment with respect to each individual loan. At December 31, 2006, included in the $8.2 million of assets that were classified as substandard, were $6.8 million of performing loans. This compares to $6.4 million and $5.1 million of adversely classified performing assets at December 31, 2005 and 2004, respectively. These amounts constitute assets that, in the opinion of management, could potentially migrate to nonperforming or doubtful status. Management believes that the December 31, 2006 level of adversely classified assets is low relative to the size and composition of the Company s loan portfolio. As the loan and lease portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of adversely classified assets will increase. This in turn may necessitate an increase to the provision for loan and lease losses in future periods.

Allowance for Credit Losses

The allowance for loan and lease losses and reserve for unfunded lending commitments, collectively referred to as the allowance for credit losses, have been established for credit losses inherent in the loan and lease portfolio and inherent in the unfunded lending commitments through a charge to earnings. The allowance for credit losses is maintained at a level management considers appropriate to provide for the

current inherent risk of loss based upon an evaluation of known and inherent risks in the loan and lease portfolio, as well as the unfunded lending commitments.

Loans deemed uncollectible are charged against the allowance for loan and lease losses, while recoveries of amounts previously charged-off are added to the allowance for loan and lease losses. Amounts are charged-off once the probability of loss has been established, with consideration given to such factors as the customer s financial condition, underlying collateral and guarantees, and general and industry economic conditions.

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

In addition to the allowance for loan and lease losses, management also estimates probable losses related to unfunded lending commitments. In 2006, the Company reclassified the reserve for unfunded lending commitments from the allowance for loan and losses to other liabilities for all periods presented. Additions to the reserve for unfunded lending commitments are made by charges to other expenses.

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

	December 31,									
	2006		**2005**		**2004**		**2003**		**2002**	
	Amount	**Percent of Loans in Each Category to Total Loans**	**Amount**	**Percent of Loans in Each Category to Total Loans**	**Amount**	**Percent of Loans in Each Category to Total Loans**	**Amount**	**Percent of Loans in Each Category to Total Loans**	**Amount**	**Percent of Loans in Each Category to Total Loans**
	(Dollars in thousands)									
Commercial loans and leases	$ 7,944	51.8 %	$ 7,002	46.1 %	$ 6,251	45.4 %	$ 4,529	40.8 %	$ 5,051	41.9 %
Residential mortgage loans	1,440	26.2 %	1,653	32.2 %	1,644	35.7 %	1,922	45.0 %	1,757	44.4 %
Consumer and other loans	2,086	22.0 %	1,894	21.7 %	1,545	18.9 %	1,092	14.2 %	905	13.7 %
Unallocated	907	NA	1,116	NA	2,014	NA	3,147	NA	2,071	NA
Total	$ 12,377	100.0 %	$ 11,665	100.0 %	$ 11,454	100.0 %	$ 10,690	100.0 %	$ 9,784	100.0 %

Assessing the appropriateness of the allowance for loan and leases losses involves substantial uncertainties and is based upon management s evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing various factors. Management s methodology to estimate loss exposure includes an analysis of individual loans deemed to be impaired, reserve allocations for various loan types based on payment status or loss experience and an unallocated allowance that is maintained based on management s assessment of many factors including the growth, composition and quality of the loan portfolio, historical loss experiences, general economic conditions and other pertinent factors. These risk factors are continuously reviewed and revised by management where conditions indicate that the estimates initially applied are different from actual results. Management employs a similar process with respect to unfunded lending commitments.

A portion of the allowance for loan and lease losses is not allocated to any specific segment of the loan portfolio. This non-specific allowance is maintained for two primary reasons: (i) there exists an inherent subjectivity and imprecision to the analytical processes employed, and (ii) the prevailing business environment, as it is affected by changing economic conditions and various external factors, may impact the portfolio in ways currently unforeseen. Management, therefore, has established and maintains a non-specific allowance for loan and lease losses. The amount of this measurement imprecision allocation was $907,000 at December 31, 2006, compared to $1.1 million at December 31, 2005.

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

The factors supporting the allowance for loan and lease losses and the reserve for unfunded lending commitments do not diminish the fact that the entire allowance for loan and lease losses and the reserve for unfunded lending commitments are available to absorb losses in the loan portfolio and related commitment portfolio, respectively. The Company s primary concern is the appropriateness of the total allowance for loan and lease losses and reserve for unfunded lending commitments. Based on the evaluation described above, management believes that the year-end allowance for loan and lease losses and reserve for unfunded lending commitments are appropriate.

During 2006, 2005 and 2004, the Bank made additions to the allowance for loan and lease losses of $1.2 million, $1.4 million and $836,000 and experienced net charge-offs of $490,000, $1.2 million and $72,000, respectively. At December 31, 2006, the allowance for loan and leases losses stood at $12.4 million and represented 875.9% of nonperforming loans and 1.23% of total loans outstanding. This compares to an allowance for loan and lease losses of $11.7 million, representing 2810.8% of nonperforming loans and 1.23% of total loans outstanding at December 31, 2005.

During 2006, the Bank made additions to reserve for unfunded lending commitments by $64,000, bringing the balance to $567,000 at December 31, 2006. This compares to the December 31, 2005 balance in the reserve for unfunded lending commitments of $503,000.

An analysis of the activity in the allowance for credit losses is as follows:

	Year ended December 31, 2006 (In thousands)	2005	2004	2003	2002
Allowance for Loan and Lease Losses					
Balance at beginning of year	$ 11,665	$ 11,454	$ 10,690	$ 9,784	$ 8,279
Loans charged-off:					
Commercial loans and leases	(472)	(1,266)	(98)	(565)	(400)
Residential mortgage loans				(17)	
Consumer and other loans	(47)	(8)	(52)	(64)	(93)
Total loans charged-off	(519)	(1,274)	(150)	(646)	(493)
Recoveries of loans previously charged-off:					
Commercial loans and leases	19	61	70	4	110
Residential mortgage loans					40
Consumer and other loans	10	1	8	24	40
Total recoveries of loans previously charged-off	29	62	78	28	190
Net (charge-offs) recoveries	(490)	(1,212)	(72)	(618)	(303)
Provision for loan losses charged against income	1,202	1,423	836	1,524	1,808
Balance at end of year	12,377	11,665	11,454	10,690	9,784
Reserve for Unfunded Lending Commitments (1)					
Balance at beginning of year	503	452	388	312	245
(Credit) provision for unfunded lending commitments	64	51	64	76	67
Balance at end of year	567	503	452	388	312
Allowance for Credit Losses					
Balance at end of year	$ 12,944	$ 12,168	$ 11,906	$ 11,078	$ 10,096

(1) In 2006, the Company reclassified the reserve for unfunded lending commitments from the allowance for loan and lease losses to other liabilities for all periods presented.

Investments

Total investments (consisting of overnight investments, investment securities, MBSs, and FHLB stock) totaled $397.7 million, or 26.9% of total assets, at December 31, 2006. This compares to total investments of $412.2 million, or 28.6% of total assets, as of December 31, 2005. The decrease of $14.5 million, or 3.5%, was centered in the decline of investment securities of $47.5 million, but partially offset by an increase in overnight investments of $26.9 million. All investment securities and MBSs at December 31, 2006 and 2005 were classified as securities available for sale. At December 31, 2006, the investment portfolio carried a total net unrealized loss of $4.6 million, compared to $5.0 million of net unrealized loss at December 31, 2005, with the primary driver of the change in unrealized gain/loss being the impact of changes in interest rates.

The investment portfolio provides the Company a source of short-term liquidity and acts as a counterbalance to loan and deposit flows. Excluding the investment portfolio restructuring in September 2006 as referenced on page 33, the Company made minimal purchases of investment securities and MBSs as the Company s continued strategy is to target growth of internally generated, higher-yielding assets, such as commercial and consumer loans.

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

	Amortized Cost (In thousands)	Unrealized Gains	Losses	Fair Value
At December 31, 2006:				
U.S. Agency obligations	$ 85,992	$ 1	$ (704)	$ 85,289
Corporate debt securities	12,122	7	(105)	12,024
Trust preferred securities	6,152	49	(89)	6,112
U.S. Agency mortgage-backed securities	157,323	114	(2,271)	155,166
Collateralized mortgage obligations	86,935	18	(1,657)	85,296
Total	$ 348,524	$ 189	$ (4,826)	$ 343,887
At December 31, 2005:				
U.S. Agency obligations	$ 125,915	$	$ (1,921)	$ 123,994
Corporate debt securities	21,214	57	(608)	20,663
Trust preferred securities	6,199	108	(5)	6,302
U.S. Agency mortgage-backed securities	174,542	404	(1,486)	173,460
Collateralized mortgage obligations	62,907		(1,509)	61,398
Total	$ 390,777	$ 569	$ (5,529)	$ 385,817
At December 31, 2004:				
U.S. Agency obligations	$ 74,330	$ 219	$ (358)	$ 74,191
Corporate debt securities	25,388	528	(43)	25,873
Trust preferred securities	4,235	301		4,536
U.S. Agency mortgage-backed securities	97,210	1,082	(333)	97,959
Collateralized mortgage obligations	62,371	52	(436)	61,987
Total	$ 263,534	$ 2,182	$ (1,170)	$ 264,546

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

	Within one year		After one, but within five years		After five, but within ten years		After ten years	
	Fair value	Weighted average yield	Fair value	Weighted average yield	Fair value	Weighted average yield	Fair value	Weighted average yield
	(Dollars in thousands)							
At December 31, 2006:								
U.S. Agency obligations	$ 9,959	2.90 %	$ 75,330	4.78 %	$	0.00 %	$	0.00 %
Corporate debt securities	6,034	5.33 %	5,990	4.93 %		0.00 %		0.00 %
Trust preferred securities		0.00 %		0.00 %		0.00 %	6,112	7.63 %
U.S. Agency mortgage-backed securities		0.00 %		0.00 %	15,136	4.55 %	140,030	4.82 %
Collateralized mortgage obligations		0.00 %		0.00 %	2,604	4.06 %	82,692	5.01 %
Total	$ 15,993	3.81 %	$ 81,320	4.79 %	$ 17,740	4.48 %	$ 228,834	4.96 %
At December 31, 2005:								
U.S. Agency obligations	$ 14,815	2.81 %	$ 109,179	4.11 %	$	0.00 %	$	0.00 %
Corporate debt securities	5,045	4.94 %	15,618	4.86 %		0.00 %		0.00 %
Trust preferred securities		0.00 %		0.00 %		0.00 %	6,302	7.34 %
U.S. Agency mortgage-backed securities		0.00 %		0.00 %	18,613	4.55 %	154,847	4.62 %
Collateralized mortgage obligations		0.00 %		0.00 %		0.00 %	61,398	4.52 %
Total	$ 19,860	3.35 %	$ 124,797	4.21 %	$ 18,613	4.55 %	$ 222,547	4.67 %
At December 31, 2004:								
U.S. Agency obligations	$	0.00 %	$ 74,190	3.66 %	$	0.00 %	$	0.00 %
Corporate debt securities	4,073	5.68 %	21,801	4.88 %		0.00 %		0.00 %
Trust preferred securities		0.00 %		0.00 %		0.00 %	4,536	8.40 %
U.S. Agency mortgage-backed securities		0.00 %		0.00 %		0.00 %	97,959	4.46 %
Collateralized mortgage obligations		0.00 %		0.00 %		0.00 %	61,987	4.41 %
Total	$ 4,073	5.68 %	$ 95,991	3.94 %	$	0.00 %	$ 164,482	4.54 %

Bank-Owned Life Insurance

The Bank has purchased BOLI to protect itself against the loss of key employees due to death and to offset the Bank s future obligations to its employees under its retirement and benefit plans. During 2006, 2005 and 2004, the Bank purchased $3.5 million, $0 and $2.0 million of BOLI, respectively. The Bank also conducted a tax-free exchange of a portion of its BOLI to other life insurance carriers in the fourth quarter of 2006, which should increase income from BOLI in future years. The cash surrender value of these life insurance policies was $23.1 million and $18.8 million at December 31, 2006 and 2005, respectively. The Bank recorded income from the BOLI policies of $785,000 in 2006, $691,000 in 2005 and $641,000 in 2004.

Deposits and Borrowings

The Bank continues to concentrate its time and efforts towards its deposit-gathering network. The Bank s total deposits increased on a net basis by $35.5 million, or 3.6%, during 2006, crossing the $1.0 billion mark at December 31, 2006, from $981.0 million at December 31, 2005. This increase in total deposits is summarized as follows: demand deposit accounts were up $15.2 million, or 8.2%, savings accounts were up $15.6 million, or 4.6%, and CDs were up $28.7 million, or 8.1%. Meanwhile, NOW and

money market accounts were down $18.9 million, or 21.1%, and $5.1 million, or 42.3%, respectively. Included within CD balances at December 31, 2006, were $30.0 million of brokered CDs, while the Bank did not have any brokered CDs at December 31, 2005. The Bank utilizes brokered CDs if their rates are attractive compared to wholesale funding.

In 2006, the Bank was able to achieve high single-digit percentage increases in its largest core deposit accounts (demand deposit accounts and savings accounts). However, in addition to the normally higher-yielding term deposit products, the Bank offered higher-yielding savings accounts during 2006 in an effort to attract and retain deposits. The consumer demand for higher-yielding products has gradually increased the cost of funds and changed the balance sheet mix. Core deposit accounts as percentage of total deposits decreased to 62.4% at December 31, 2006 from 64.0% at December 31, 2005.

By comparison, total deposits increased $100.3 million, or 11.4%, during 2005 and can be summarized as follows: demand deposit accounts increased $17.4 million, or 10.4%, NOW and money market accounts decreased $18.6 million, or 17.2%, savings accounts increased $1.3 million, or 0.4%, and CDs increased $104.5 million, or 42.1%, during 2005.

The following table sets forth certain information regarding deposits:

	December 31, 2006			**2005**			**2004**		
	Amount	**Percent of Total**	**Weighted Average Rate**	**Amount**	**Percent of Total**	**Weighted Average Rate**	**Amount**	**Percent of Total**	**Weighted Average Rate**
	(Dollars in thousands)								
NOW accounts	$ 70,736	7.0 %	0.67 %	$ 89,594	9.1 %	0.54 %	$ 108,159	12.3 %	0.76 %
Money market accounts	6,991	0.7 %	2.69 %	12,122	1.2 %	1.31 %	16,489	1.9 %	1.22 %
Savings accounts	356,707	35.1 %	2.81 %	341,115	34.8 %	1.66 %	339,836	38.6 %	1.25 %
Certificate of deposit accounts	381,707	37.5 %	4.45 %	353,049	36.0 %	3.34 %	248,508	28.2 %	2.55 %
Total interest bearing deposits	816,141	80.3 %	3.40 %	795,880	81.1 %	2.28 %	712,992	81.0 %	1.63 %
Noninterest bearing accounts	200,282	19.7 %	0.00 %	185,089	18.9 %	0.00 %	167,682	19.0 %	0.00 %
Total deposits	$ 1,016,423	100.0 %	3.00 %	$ 980,969	100.0 %	1.85 %	$ 880,674	100.0 %	1.32 %

At December 31, 2006, CDs with balances greater than $100,000 aggregated $144.3 million, compared to $98.0 million and $52.4 million at December 31, 2005 and 2004, respectively.

Total borrowings, excluding subordinated deferrable interest debentures, decreased $7.7 million, or 2.4%, during 2006, to $318.5 million, from $326.2 million at December 31, 2005. The Company had $252.8 million of borrowings outstanding at the end of 2004. Over the past year, the Bank s customers have increased their utilization of the Bank s cash management product suite. The increase in short-term borrowings has enabled the Bank to reduce marginally the amount of FHLB borrowings. Through the Bank s membership in the FHLB, the Company has access to a number of different funding structures. Wholesale repurchase agreements remained constant with the December 31, 2005 level of $20.0 million. The Bank may utilize wholesale repurchase agreement funding in the future if spreads are favorable compared to FHLB borrowings.

On a long-term basis, the Company intends to continue concentrating on increasing its core deposits, and will utilize FHLB borrowings or wholesale repurchase agreements as cash flows dictate, as opportunities present themselves and as part of the Bank s overall strategy to manage interest rate risk.

Subordinated Deferrable Interest Debentures

The Company has issued $18.6 million of subordinated deferrable interest debentures to its four statutory trust subsidiaries. The statutory trust subsidiaries have then participated in the issuance of pooled trust preferred securities. The regulatory capital generated from issuing the trust preferred securities helped support the Company s continued asset growth.

Liquidity and Capital Resources

Liquidity

Liquidity is defined as the ability to meet current and future financial obligations of a short-term nature. The Company further defines liquidity as the ability to respond to the needs of depositors and borrowers, as well as to earnings enhancement opportunities, in a changing marketplace.

The primary source of funds for the payment of dividends and expenses by the Company is dividends paid to it by the Bank. Bank regulatory authorities generally restrict the amounts available for payment of dividends if the effect thereof would cause the capital of the Bank to be reduced below applicable capital requirements. These restrictions indirectly affect the Company s ability to pay dividends. The primary sources of liquidity for the Bank consist of deposit inflows, loan repayments, borrowed funds, maturing investment securities and sales of securities from the available for sale portfolio. Management believes that these sources are sufficient to fund the Bank s lending and investment activities.

Management is responsible for establishing and monitoring liquidity targets as well as strategies and tactics to meet these targets. In general, the Company maintains a high degree of flexibility with a liquidity target of 10% to 30% of total assets. At December 31, 2006, overnight investments, investment securities and mortgage-backed securities available for sale amounted to $381.2 million, or 25.8% of total assets. This compares to $396.2 million, or 27.5% of total assets, at December 31, 2005. The Bank is a member of the FHLB and, as such, has access to both short- and long-term borrowings. In addition, the Bank maintains a line of credit at the FHLB as well as a line of credit with a correspondent bank. There have been no adverse trends in the Company s liquidity or capital reserves. Management believes that the Company has adequate liquidity to meet its commitments.

Commitments and Contingent Liabilities

The following table sets forth the contractual obligations of the Company:

	Payments due or commitment expiring by period				
	Total (In thousands)	Less than one year	One to three years	Four to five years	After five years
Contractual cash obligations:					
FHLB term borrowings	$ 242,198	$ 34,593	$ 68,389	$ 59,000	$ 80,216
Subordinated deferrable interest debentures	18,558				18,558
Lease obligations	11,049	1,283	1,984	1,024	6,758
Other:					
Treasury, Tax and Loan payments	1,915	1,915			
Retail repurchase agreements	54,426	54,426			
Wholesale repurchase agreements	20,000				20,000
Total contractual cash obligations	$ 348,146	$ 92,217	$ 70,373	$ 60,024	$ 125,532
Other commitments:					
Commitments to originate or purchase loans	$ 35,250	$ 35,250	$	$	$
Unused lines of credit and other commitments	205,673	94,074	19,860	687	91,052
Letters of credit	3,353	2,744	609		
Supplemental retirement benefits	2,231				2,231
Total other commitments	$ 246,507	$ 132,068	$ 20,469	$ 687	$ 93,283

In connection with the Macrolease acquisition, the Company has an obligation to issue up to 18,082 shares of its common stock over the next two years contingent upon Macrolease reaching specified performance criteria.

Capital Resources

Total shareholders equity of the Company at December 31, 2006 was $112.1 million, as compared to $104.8 million at December 31, 2005. This difference of $7.3 million was primarily attributable to net income of $7.7 million, net unrealized gains and losses on securities increasing $210,000, stock option activity (stock option exercises, share-based compensation and related tax benefits) of $2.1 million, and dividends paid of $2.9 million.

All FDIC-insured institutions must meet specified minimal capital requirements. These regulations require banks to maintain a minimum leverage capital ratio. At December 31, 2006, the Bank s Tier I leverage ratio stood at 7.18%. In addition, the FDIC has adopted capital guidelines based upon ratios of a bank s capital to total assets adjusted for risk. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. These regulations require banks to maintain minimum capital levels for capital adequacy purposes and higher capital levels to be considered well capitalized . According to these standards, the Bank had a Tier I risk-weighted capital ratio of 10.32% and a Total risk-weighted capital ratio of 11.54% at December 31, 2006. 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 FRB has also issued capital guidelines for bank holding companies. These guidelines require the Company to maintain minimum capital levels for capital adequacy purposes. 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. At December 31, 2006, the

Company s Tier I leverage ratio was 8.37%, its Tier I Risk-based capital ratio was 12.05% and its Total Risk-based capital ratio was 13.27%.

As of December 31, 2006, the Company and the Bank met all applicable minimum capital requirements and were considered well capitalized by both the FRB and the FDIC.

The Company has issued a total of $18.0 million of trust preferred securities and utilized their proceeds as Tier I capital to help support the Company s growth. If trust preferred securities are not available as a source of future Tier I capital, in addition to the available capital referenced above, the Company may use other forms of additional capital (e.g., common or preferred equity) to support its growth, which, because of less favorable tax treatment, may be a somewhat more expensive source of capital than trust preferred securities.

Impact of Inflation and Changing Prices

The consolidated financial statements and related notes thereto, included elsewhere herein, have been prepared in accordance with U.S. GAAP, which requires the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. Unlike many industrial companies, substantially all of the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company s performance than the general level of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as inflation.

Recent Accounting Developments

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123-R, *Share-Based Payment* , which was subsequently revised in April 2005 by delaying the implementation date. SFAS 123-R addresses the accounting for share-based payments to employees and non-employees, including grants of employee stock options. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB 25, *Accounting for Stock Issued to Employees* . Instead, companies are required to account for such transactions using a fair-value method and recognize the expense in the consolidated statements of operations. The Company adopted SFAS 123-R on January 1, 2006. The adoption of SFAS 123-R did not have a material impact on the Company s statement of operations and is more fully described in Notes 2 and 15 to the financial statements.

In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140* , which permits, but does not require, fair value accounting for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* . SFAS 155 also eliminated the temporary exemption for interests in securitized financial assets provided for by SFAS 133, Derivatives Implementation Group (DIG) Issue D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets* . However, in January 2007, the FASB issued interpretive guidance in SFAS 133, DIG Issue B40, *Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets* , in which the FASB concluded that a securitized interest in prepayable financial assets was not subject to the bifurcation requirements of SFAS 155 provided that the securitized interest met both the following criteria: (1) the right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and (2) the securitized interest itself does not contain an embedded derivative for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets. The guidance in DIG Issue B40 is effective upon the adoption of SFAS 155. SFAS 155 is effective for all financial instruments acquired or issued after December 31, 2006, as well as to those hybrid financial

instruments that had been previously bifurcated under SFAS 133. As of December 31, 2006, the Company did not have any hybrid financial instruments which were previously bifurcated under SFAS 133. Additionally, the guidance provided for in DIG Issue B40 is expected to allow the Company to continue to purchase mortgage-backed securities without applying the bifurcation requirements of SFAS 155. The Company does not anticipate the adoption of SFAS 155 will have a material effect on its financial statements.

In March 2006, the FASB issued SFAS 156, *Accounting for Servicing of Financial Assets* , an amendment of SFAS 140. This standard requires servicing assets and servicing liabilities be initially measured at fair value along with any derivative instruments used to mitigate inherent risks. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The Company does not anticipate SFAS 156 will materially impact its consolidated financial statements upon adoption on January 1, 2007.

In March 2006, the FASB Emerging Issues Task Force (EITF) issued interpretive guidance in Issue 06-4 (EITF 06-4), in which agreements by companies to share a portion of the proceeds of life insurance policies with an employee during the postretirement period is a postretirement benefit arrangement that must be accounted for under SFAS 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* . Under EITF 06-4, the EITF also concluded the purchase of a split-dollar life insurance policy does not constitute a settlement of the postretirement benefit as defined in SFAS 106. Thus, companies will be required to record a liability upon adoption of EITF 06-4, which is effective for periods beginning after December 15, 2007. The Company is currently evaluating the impact EITF 06-4 will have on its consolidated financial statements upon adoption on January 1, 2008.

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS 109, *Accounting for Income Taxes* . FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not anticipate the adoption of FIN 48 will materially impact its financial statements upon adoption on January 1, 2007.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* . SAB 108 provides guidance regarding the process of quantifying financial statements misstatements and dictates that a company should quantify errors using both a balance sheet approach (the iron curtain method) and an income statement approach (the rollover approach). The balance sheet approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement s year of origination. The income statement method quantifies a misstatement based on the amount of the error originating in the current year income statement, while ignoring the carryover effects of a prior year misstatement. SAB 108 indicates that a company should quantify an error under both methods and evaluate the materiality under both methods. If deemed material, a company is required to adjust its financial statements. SAB 108 was effective for the first fiscal year ending after November 15, 2006. The Company adopted SAB 108 in the fourth quarter of 2006. SAB 108 did not have a material impact upon adoption.

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), *Fair Value Measurements* . SFAS 157 provides guidance for measuring assets and liabilities at fair value. This standard is applicable whenever other standards require or permit assets and liabilities to be measured at fair value, but does not expand upon the use of fair value in any new circumstances. SFAS 157 establishes a fair value hierarchy that gives the highest priority to quoted prices in active markets and the lowest priority to unobservable

data and requires fair value measurements to be disclosed by level within the hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact SFAS 157 will have on its consolidated financial statements upon adoption on January 1, 2008.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities . SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and to provide additional information that will help investors and other users of financial statements to understand more easily the effect on earnings of the company s choice to use fair value. It also requires companies to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The Company is currently evaluating the impact SFAS 159 will have on its consolidated financial statements upon adoption on January 1, 2008.

ITEM 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Asset and Liability Management

The principal objective of the Company s asset and liability management process is to maximize profit potential while minimizing the vulnerability of its operations to changes in interest rates by managing the ratio of interest rate sensitive assets to interest rate sensitive liabilities within specified maturity or repricing periods. The asset and liability management process is dependent on numerous assumptions, many of which require significant judgments by the Company. The Company s actions in this regard are taken under the guidance of the Bank s Asset/Liability Committee (ALCO) that is comprised of members of senior management. The ALCO generally meets monthly and is actively involved in formulating the economic assumptions that the Company uses in its financial planning and budgeting process and establishes policies which control and monitor the sources, uses and pricing of funds.

The ALCO manages the Company s interest rate risk position using both income simulation and interest rate sensitivity gap analysis. Income simulation is the primary tool for measuring the interest rate risk inherent in the Company s balance sheet at a given point in time by showing the effect on net interest income, over a 24-month period, of interest rate ramps of up to 200 basis points. These simulations take into account repricing, maturity and prepayment characteristics of individual products. The ALCO reviews simulation results to determine whether the exposure to income resulting from changes in market interest rates remains within established tolerance levels over both a 12-month and 24-month horizon, and develops appropriate strategies to manage this exposure. The Company s guidelines for interest rate risk specify that if interest rates were to shift up or down 200 basis points over both a 12-month and 24-month period, estimated net interest income should decline by no more than 10.0%. As of December 31, 2006, net interest income simulation indicated that the Company s exposure to changing interest rates was within these tolerances. The ALCO reviews the methodology utilized for calculating interest rate risk exposure and will adopt changes based upon changing market conditions or industry standards.

The following table presents the estimated impact of interest rate ramps on estimated net interest income over a 24-month period beginning January 1, 2007:

	Estimated impact on net interest income	
	Dollar change	Percent change
	(Dollars in thousands)	
Initial Twelve Month Period:		
Up 200 basis point ramp	$ (588)	(1.37)%
Down 200 basis point ramp	(530)	(1.24)%
Subsequent Twelve Month Period:		
Up 200 basis point ramp	$ (3,603)	(7.98)%
Down 200 basis point ramp	(1,881)	(4.17)%

The Company also uses interest rate sensitivity gap analysis to provide a more general overview of its interest rate risk profile. The interest rate sensitivity gap is defined as the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds interest rate sensitive assets. At December 31, 2006, the Company s cumulative one-year gap was a negative $114 million, or 7.9% of total assets, compared to a negative $140 million, or 9.7% of total assets at the end of 2005.

The following table presents the repricing schedule for interest-earning assets and interest-bearing liabilities at December 31, 2006. To the extent applicable, amounts of assets and liabilities that mature or reprice within a particular period were determined in accordance with their contractual terms. Investment securities are allocated based upon expected call dates. Loans and MBSs have been allocated based upon expected amortization and prepayment rates based on historical performance and market expectations. Savings, NOW and money market deposit accounts, which have no contractual term and are subject to immediate repricing, are anticipated to behave more like core accounts and therefore are presented as spread evenly over the first three years. Nonetheless, this presentation does not reflect lags that may occur in the actual repricing of these deposits.

	Within Three Months	Over Three to Six months	Over Six to Twelve months	Over One Year to Five Years	Over Five Years	Total
	(Dollars in thousands)					
Interest-earning assets:						
Overnight investments	$ 37,295	$	$	$	$	$ 37,295
Investment securities	7,005	7,000	4,005	81,485	3,930	103,425
Mortgage-backed securities	12,222	11,425	32,744	112,897	71,174	240,462
FHLB Stock	16,530					16,530
Commercial loans and leases	147,945	40,838	68,207	241,124	21,676	519,790
Residential mortgage loans	15,535	15,806	33,582	150,098	48,924	263,945
Consumer and other loans	72,823	8,253	15,898	80,688	42,895	220,557
Total interest-earning assets	309,355	83,322	154,436	666,292	188,599	1,402,004
Interest-bearing liabilities:						
NOW accounts	5,895	5,895	11,789	47,157		70,736
Money market accounts	583	583	1,165	4,660		6,991
Savings accounts	29,800	29,800	59,600	237,507		356,707
Certificate of deposit accounts	128,205	91,309	138,528	23,618	47	381,707
Overnight & short-term borrowings	56,341					56,341
FHLB and other borrowings	40,022	18,940	32,437	122,288	48,511	262,198
Subordinated deferrable interest debentures	10,310			5,155	3,093	18,558
Total interest-bearing liabilities	271,156	146,527	243,519	440,385	51,651	1,153,238
Net interest sensitivity gap during the period	$ 38,199	$ (63,205)	$ (89,083)	$ 225,907	$ 136,948	$ 248,766
Cumulative gap 12/31/06	$ 38,199	$ (25,006)	$ (114,089)	$ 111,818	$ 248,766	
Cumulative gap 12/31/05	$ 21,661	$ (40,171)	$ (140,494)	$ 78,829	$ 222,406	
Interest-sensitive assets as a percent of Interest-sensitive liabilities (cumulative)	114.09 %	94.01 %	82.75 %	110.15 %	121.57 %	
Cumulative gap as a percent of total assets	2.65 %	-1.73 %	-7.91 %	7.75 %	17.25 %	

The preceding table does not necessarily indicate the impact of general interest rate movements on the Company s net interest income because the repricing of various assets and liabilities is discretionary and is subject to competitive and other factors. As a result, assets and liabilities indicated as repricing within the same period may, in fact, reprice at different times and at different rate levels.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The index to financial statements is included on page 61 of this annual report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING OR FINANCIAL DISCLOSURE

There were no changes in, or disagreements with, accountants on accounting or financial disclosure as defined by Item 304 of Regulation S-K.

ITEM 9A. CONTROLS AND PROCEDURES

As required by Rule 13a-15 under the Exchange Act of 1934, the Company carried out an evaluation of the effectiveness of the design and operation of the Company s disclosure controls and procedures as of the end of the period covered by this report. This evaluation was carried out under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and the Company s Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective as of the end of the period covered by this report.

There have been no significant changes in the Company s internal control over financial reporting during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to affect, the Company s internal control over financial reporting. The Company s management discusses with and discloses these matters to the Audit Committee of the Board of Directors and the Company s auditors.

ITEM 9B. OTHER INFORMATION

There is no other information to report.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information concerning directors required by this item, including the Audit Committee and the Audit Committee financial expert, is incorporated herein by reference to the sections entitled Election of Directors and Section 16(a) Beneficial Ownership Reporting Compliance in the Company s Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC.

The following table sets forth the executive officers of the Company as of the date hereof.

Name	Age	Position
Merrill W. Sherman	58	President and Chief Executive Officer
Linda H. Simmons	47	Chief Financial Officer and Treasurer
Jeffrey W. Angus	51	Vice President
James V. DeRentis	45	Vice President

Merrill W. Sherman. Ms. Sherman has served as President and Chief Executive Officer of the Company and Bank since their formation. Ms. Sherman is also a director of The Providence Journal Company, a BELO Corp. subsidiary.

Linda H. Simmons. Ms. Simmons has served as Chief Financial Officer and Treasurer of the Company and Bank since July 2005 and served as the Bank s Executive Vice President Finance and Treasurer from September 2004 to July 2005. From 1995 until joining the Bank, Ms. Simmons was with Fleet Financial Corp. s Treasury Group where she held various positions with responsibilities in the asset/liability management area.

Jeffrey W. Angus. Mr. Angus has served as Vice President of the Company and Executive Vice President and Chief Operating Officer of the Bank since December 2005. From 1998 until 2004, Mr. Angus served as senior vice president of information systems and as a corporate officer at New England Business Service, Inc.

James V. DeRentis. Mr. DeRentis has served as Vice President of the Company since December 2005 and the Bank s Chief Business Officer since October 2005. Mr. DeRentis previously served as the Bank s Executive Vice President Retail Banking from October 2001 through September 2005. Immediately

prior, Mr. DeRentis served as the Bank s Senior Vice President Retail Banking from December 1998 through October 2001.

Code of Ethics and Governance Principles

The Company has adopted a Code of Ethics which applies to all directors, officers and employees of the Company and the Bank, including the Chief Executive Officer (CEO), Chief Financial Officer (CFO), Controller and Chief Auditor, as supplemented by a Code of Ethical Conduct for Executive Officers and Senior Financial Officers, which meets the requirements of a code of ethics as defined in Item 406 of Regulation S-K. Our Board of Directors has also adopted Corporate Governance Guidelines and Principles (the Guidelines), which along with the charters of Board committees provide the framework for the governance of the Company. The Company will provide a copy of the Codes, the Guidelines and/or committee charters to shareholders, without charge, upon request directed to the Investor Relations Contact listed on the Company s website, http://www.bankri.com, under Investor Relations . The Company has posted the Codes, the Guidelines and the committee charters on the Company s website under Investor Relations/Governance Documents . The Company intends to disclose any amendment to, or waiver of, a provision of the Codes for the CEO, CFO, Controller or persons performing similar functions by posting such information on its website and filing a Form 8-K as required by the rules of the Nasdaq Global Select Market SM.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the sections entitled Compensation of Directors , Compensation Discussion and Analysis , Compensation Committee Report and Executive Compensation in the Company s Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC.

The information set forth under the heading Compensation Committee Report in the Company s Definitive Proxy Statement is furnished and shall not be deemed as filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not deemed incorporated by reference in any filing under the Securities Act of 1933, as amended.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the Sections entitled Common Stock Ownership of Certain Beneficial Owners and Management in the Company s Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC.

Equity Compensation Plan Information

The following table sets forth information about the Company s equity compensation plans as of December 31, 2006:

Plan category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity Compensation Plans Approved by Security Holders	456,021 (1)	$ 24.52	161,383 (2)
Equity Compensation Plans Not Approved by Security Holders	0	N/A	0
Total	456,021	$ 24.52	161,383

(1) Includes 403,021 shares issuable upon exercise of outstanding awards granted under the Bancorp Rhode Island, Inc. 2002 Equity Incentive Plan and predecessor plan (Amended and Restated Bancorp Rhode Island, Inc. 1996 Incentive and Nonqualified Stock Option Plan) and 53,000 shares issuable upon exercise of outstanding awards granted under the Amended and Restated Bancorp Rhode Island, Inc. Non-Employee Directors Stock Plan.

(2) Includes 142,383 shares reserved for awards under the Bancorp Rhode Island, Inc. 2002 Equity Incentive Plan and predecessor plan and 19,000 shares reserved for awards under the Amended and Restated Bancorp Rhode Island, Inc. Non-Employee Directors Stock Plan.

Additional information regarding these equity compensation plans is contained in Note 15 to the Company s Consolidated Financial Statements included in this annual report.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the sections entitled Transactions with Management and Election of Directors in the Company s Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the Section entitled Independent Accountant Fees and Services in the Company s Definitive Proxy Statement for the 2007 Annual Meeting of Shareholders to be filed with the SEC.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENTS SCHEDULES

(a) (1) Financial Statements

The following consolidated financial statements appear in response to Item 8 of this report commencing on the page numbers specified below:

Management s Report on Internal Control Over Financial Reporting	F-1
Report of Independent Registered Public Accounting Firm on Management s Assessment of and the Effectiveness of Internal Control Over Financial Reporting	F-2
Report of Independent Registered Public Accounting Firm	F-3
Consolidated Balance Sheets as of December 31, 2006 and 2005	F-4
Consolidated Statements of Operations for the Years Ended December 31, 2006, 2005 and 2004	F-5
Consolidated Statements of Changes in Shareholders Equity for the Years Ended December 31, 2006, 2005 and 2004	F-6
Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004	F-7
Notes to Consolidated Financial Statements	F-8

(2) Financial Statement Schedules

All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

(3) Exhibits

Exhibit No.	**Description**
3.1	Articles of Incorporation of the Company, as amended(1)
3.2	By-laws of the Company, as amended(2)
10.1	Amended and Restated Employment Agreement of Merrill W. Sherman dated February 20, 2007
10.2	Amended and Restated Employment Agreement of Linda H. Simmons dated February 20, 2007
10.3	Amended and Restated Employment Agreement of Jeffrey W. Angus February 20, 2007
10.4	Amended and Restated Employment Agreement of James V. DeRentis dated February 20, 2007
10.5	Amended and Restated 1996 Incentive and Nonqualified Stock Option Plan(3)
10.6	Amended and Restated Non-Employee Director Stock Plan(4)
10.6(a)	Amendment to Amended and Restated Non-Employee Director Stock Plan(5)
10.6(b)	Second Amendment to Amended and Restated Non-Employee Director Stock Plan(6)
10.7(a)	Bank Rhode Island Supplemental Executive Retirement Plan, as amended by Amendments No. 1 and No. 2(1)

10.7(b)	Amendment No. 3 to Bank Rhode Island Supplemental Executive Retirement Plan(2)
10.7(c)	Amendment No. 4 to Bank Rhode Island Supplemental Executive Retirement Plan(7)
10.7(d)	Amendment No. 5 to Bank Rhode Island Supplemental Executive Retirement Plan(8)
10.7(e)	Amendment No. 6 to Bank Rhode Island Supplemental Executive Retirement Plan(9)
10.8	Bank Rhode Island Nonqualified Deferred Compensation Plan, as amended by Amendment No. 1(1)
10.8(a)	Amendment No. 2 to Bank Rhode Island Nonqualified Deferred Compensation Plan(10)
10.9	Executive Incentive Bonus Plan(11)
10.10	Bank Rhode Island 2002 Supplemental Executive Retirement Plan(10)
10.10(a)	Amendment No. 1 to Bank Rhode Island 2002 Supplemental Executive Retirement Plan(12)
10.10(b)	Amendment No. 2 to Bank Rhode Island 2002 Supplemental Executive Retirement Plan(13)
10.10(c)	Amendment No. 4 to Bank Rhode Island 2002 Supplemental Executive Retirement Plan(2)
10.10(d)	Amendment No. 6 to Bank Rhode Island 2002 Supplemental Executive Retirement Plan
10.11	Restricted Stock Agreement by and among Bancorp Rhode Island, Inc., Bank Rhode Island and Merrill W. Sherman(14)
10.12	Form of Bank Rhode Island Split Dollar Agreement(8)
10.13	2002 Equity Incentive Plan(15)
11	Computation of earnings per share(16)
21	List of Subsidiaries
23	Consent of KPMG LLP, as independent registered public accountants for the Company
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

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(1) Incorporated by reference from the Company s Registration Statement on Form S-4, SEC File No. 333-33182

(2) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

(3) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2000.

(4) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended September 30, 2000.

(5) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2002.

(6) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2006.

(7) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2001.

(8) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended March 31, 2002.

(9) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2004.

(10) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2002.

(11) Incorporated by reference from the Company s Current Report on Form 8-K dated February 9, 2005.

(12) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2003.

(13) Incorporated by reference from the Company s Current Report on Form 8-K dated January 21, 2005.

(14) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the period ended March 31, 2001.

(15) Incorporated by reference to Appendix B to the Company s Definitive Proxy Statement on Schedule 14A filed on April 15, 2005.

(16) The calculation of earnings per share is set forth as Note 20 to the Company s audited consolidated financial statements.

Management contract or compensatory plan or arrangement.

BANCORP RHODE ISLAND, INC.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	BANCORP RHODE ISLAND, INC.	
Date: March 9, 2007	By:	/s/ Merrill W. Sherman
		Merrill W. Sherman
		President and Chief Executive Officer

Each person whose signature appears below constitutes and appoints each of Merrill W. Sherman or Linda H. Simmons, or either of them, each acting alone, his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for such person and in his or her name, place and stead, in any and all capacities in connection with the annual report on Form 10-K of Bancorp Rhode Island, Inc. for the year ended December 31, 2006, to sign any and all amendments to the Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or their substitutes or substitute, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ Merrill W. Sherman
Merrill W. Sherman,
President, Chief Executive Officer and Director (Principal Executive Officer)
Date: March 9, 2007

/s/ Linda H. Simmons
Linda H. Simmons,
Chief Financial Officer and Treasurer (Principal Financial Officer)
Date: March 9, 2007

/s/ Michael J. Hebert
Michael J. Hebert,
Controller (Principal Accounting Officer)
Date: March 9, 2007

/s/ Karen Adams
Karen Adams, Director
Date: March 9, 2007

/s/ Meredith A. Curren
Meredith A. Curren, Director
Date: March 9, 2007

/s/ Bogdan Nowak
Bogdan Nowak, Director
Date: March 9, 2007

/s/ Anthony F. Andrade
Anthony F. Andrade, Director
Date: March 9, 2007

/s/ Karl F. Ericson
Karl F. Ericson, Director
Date: March 9, 2007

/s/ Cheryl W. Snead
Cheryl W. Snead, Director
Date: March 9, 2007

/s/ John R. Berger
John R. Berger, Director
Date: March 9, 2007

/s/ Mark R. Feinstein
Mark R. Feinstein, Director
Date: March 9, 2007

/s/ Pablo Rodriguez
Pablo Rodriguez, Director
Date: March 9, 2007

/s/ Malcolm G. Chace
Malcolm G. Chace, Director and Chairman of the Board
Date: March 9, 2007

/s/ Edward J. Mack
Edward J. Mack, Director
Date: March 9, 2007

/s/ John A. Yena
John A. Yena, Director
Date: March 9, 2007

/s/ Ernest J. Chornyei, Jr.
Ernest J. Chornyei, Jr., Director
Date: March 9, 2007

/s/ Michael E. McMahon
Michael E. McMahon, Director
Date: March 9, 2007

BANCORP RHODE ISLAND, INC.

Management s Report on Internal Control
Over Financial Reporting

The management of Bancorp Rhode Island, Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting. Bancorp Rhode Island Inc. s internal control system was designed to provide reasonable assurance to the Company s management and board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Bancorp Rhode Island, Inc. s management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2006. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on our assessment we believe that, as of December 31, 2006, the Company s internal control over financial reporting is effective based on those criteria.

Bancorp Rhode Island, Inc. s Independent Registered Public Accounting Firm has issued an audit report on our assessment of the Company s internal control over financial reporting. This report appears on page F-2 of this annual report.

Merrill W. Sherman	Linda H. Simmons
President and	Chief Financial Officer and
Chief Executive Officer	Treasurer

BANCORP RHODE ISLAND, INC.

Report of Independent Registered Public Accounting Firm on Management s Assessment of and the Effectiveness of Internal Control Over Financial Reporting

The Board of Directors and Shareholders
Bancorp Rhode Island, Inc.:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Bancorp Rhode Island, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commissions (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commissions (COSO). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commissions (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 9, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Providence, Rhode Island
March 9, 2007

BANCORP RHODE ISLAND, INC.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Bancorp Rhode Island, Inc.:

We have audited the accompanying consolidated balance sheets of Bancorp Rhode Island, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bancorp Rhode Island, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Bancorp Rhode Island, Inc. and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 9, 2007 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP
Providence, Rhode Island
March 9, 2007

BANCORP RHODE ISLAND, INC.

Consolidated Balance Sheets

Assets	December 31, 2006 (In thousands)	2005
Assets:		
Cash and due from banks	$ 24,469	$ 30,177
Overnight investments	37,295	10,370
Total cash and cash equivalents	61,764	40,547
Investment securities available for sale (amortized cost of $104,266 and $153,328, respectively)	103,425	150,959
Mortgage-backed securities available for sale (amortized cost of $244,258 and $237,449, respectively)	240,462	234,858
Total available for sale securities	343,887	385,817
Stock in the Federal Home Loan Bank of Boston	16,530	16,062
Loans and leases receivable:		
Commercial loans and leases	519,790	438,309
Residential mortgage loans	263,945	306,016
Consumer and other loans	220,557	206,481
Total loans and leases receivable	1,004,292	950,806
Allowance for loan and lease losses	(12,377)	(11,665)
Net loans and leases receivable	991,915	939,141
Premises and equipment, net	13,736	14,858
Goodwill, net	11,317	11,234
Accrued interest receivable	6,755	6,965
Investment in bank-owned life insurance	23,148	18,824
Prepaid expenses and other assets	10,047	9,334
Total assets	$ 1,479,099	$ 1,442,782
Liabilities and Shareholders Equity		
Liabilities:		
Deposits:		
Demand deposit accounts	$ 200,282	$ 185,089
NOW accounts	70,736	89,594
Money market accounts	6,991	12,122
Savings accounts	356,707	341,115
Certificate of deposit accounts	381,707	353,049
Total deposits	1,016,423	980,969
Overnight and short-term borrowings	56,341	26,238
Wholesale repurchase agreements	20,000	20,000
Federal Home Loan Bank of Boston borrowings	242,198	279,973
Subordinated deferrable interest debentures	18,558	18,558
Other liabilities	13,494	12,212
Total liabilities	1,367,014	1,337,950
Shareholders equity:		
Preferred stock, par value $0.01 per share, authorized 1,000,000 shares: Issued and outstanding: none		
Common stock, par value $0.01 per share, authorized 11,000,000 shares: Issued and outstanding: 4,792,380 and 4,719,126 shares, respectively	48	47
Additional paid-in capital	67,960	65,768
Retained earnings	47,091	42,241
Accumulated other comprehensive loss, net	(3,014)	(3,224)
Total shareholders equity	112,085	104,832
Total liabilities and shareholders equity	$ 1,479,099	$ 1,442,782

See accompanying notes to consolidated financial statements.

BANCORP RHODE ISLAND, INC.

Consolidated Statements of Operations

	Year Ended December 31,		
	2006	2005	2004
	(In thousands, except per share data)		
Interest and dividend income:			
Loans and leases	$ 62,992	$ 53,822	$ 47,112
Mortgage-backed securities	10,542	9,313	5,709
Investment securities	6,245	5,537	4,452
Overnight investments	517	201	138
Federal Home Loan Bank of Boston stock dividends	906	647	308
Total interest and dividend income	81,202	69,520	57,719
Interest expense:			
Deposits	22,476	14,521	10,922
Overnight and short-term borrowings	2,124	652	157
Wholesale repurchase agreements	870	276	
Federal Home Loan Bank of Boston borrowings	12,044	9,898	7,505
Subordinated deferrable interest debentures	1,460	1,272	1,041
Total interest expense	38,974	26,619	19,625
Net interest income	42,228	42,901	38,094
Provision for loan and lease losses	1,202	1,423	836
Net interest income after provision for loan and lease losses	41,026	41,478	37,258
Noninterest income:			
Service charges on deposit accounts	5,055	4,561	4,514
Commissions on nondeposit investment products	872	849	973
Income from bank-owned life insurance	785	691	641
Loan related fees	694	1,024	541
Commissions on loans originated for others	159	184	71
Net (loss) gain on available for sale securities	(859)	181	90
Net gain on sales of premises and equipment			535
Other income	2,282	1,784	1,216
Total noninterest income	8,988	9,274	8,581
Noninterest expense:			
Salaries and employee benefits	20,636	19,476	17,072
Occupancy	3,564	3,126	2,669
Data processing	2,880	2,759	2,832
Professional services	2,186	2,017	1,965
Marketing	1,880	1,584	1,429
Equipment	1,407	1,569	1,591
Loan servicing	917	968	1,092
Loan workout and other real estate owned	188	217	110
Other expenses	5,069	4,627	4,169
Total noninterest expense	38,727	36,343	32,929
Income before income taxes	11,287	14,409	12,910
Income tax expense	3,576	4,840	4,296
Net income	$ 7,711	$ 9,569	$ 8,614
Weighted average shares outstanding basic	4,766,854	4,478,081	3,975,413
Weighted average shares outstanding diluted	4,920,569	4,697,134	4,222,856
Per share data:			
Basic earnings per common share	$ 1.62	$ 2.14	$ 2.17
Diluted earnings per common share	$ 1.57	$ 2.04	$ 2.04
Cash dividends declared per common share	$ 0.60	$ 0.60	$ 0.58

See accompanying notes to consolidated financial statements.

BANCORP RHODE ISLAND, INC.

Consolidated Statements of Changes in Shareholders Equity
For Years Ended December 31, 2006, 2005 and 2004

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
			(In thousands, except per share info)			
Balance at December 31, 2003	$	$ 39	$ 41,439	$ 29,074	$ 1,555	72,107
Net income				8,614		8,614
Other comprehensive income:						
Unrealized holding losses on securities available for sale, net of taxes of $432					(838)	(838)
Reclassification adjustment, net of taxes of $31					(59)	(59)
Comprehensive income						7,717
Exercise of stock options			566			566
Exercise of stock warrants		1	699			700
Tax benefit from exercise of stock options			113			113
Share-based compensation			35			35
Dividends on common stock ($0.58 per common share)				(2,315)		(2,315)
Balance at December 31, 2004		40	42,852	35,373	658	78,923
Net income				9,569		9,569
Other comprehensive income:						
Unrealized holding losses on securities available for sale, net of taxes of $2,027					(3,764)	(3,764)
Reclassification adjustment, net of taxes of $63					(118)	(118)
Comprehensive income						5,687
Proceeds from stock offering, net		7	21,450			21,457
Acquisition of Macrolease			250			250
Exercise of stock options			825			825
Share-based compensation			49			49
Tax benefit from exercise of stock options			309			309
Common stock issued for incentive stock award, net			33			33
Dividends on common stock ($0.60 per common share)				(2,701)		(2,701)
Balance at December 31, 2005		47	65,768	42,241	(3,224)	104,832
Net income				7,711		7,711
Other comprehensive income:						
Unrealized holding losses on securities available for sale, net of taxes of $122					(348)	(348)
Reclassification adjustment, net of taxes of $(301)					558	558
Comprehensive income						7,921
Exercise of stock options		1	1,662			1,663
Acquisition of Macrolease			83			83
Share-based compensation			186			186
Tax benefit from exercise of stock options			261			261
Dividends on common stock ($0.60 per common share)				(2,861)		(2,861)
Balance at December 31, 2006	$	$ 48	$ 67,960	$ 47,091	$ (3,014)	$ 112,085

See accompanying notes to consolidated financial statements.

BANCORP RHODE ISLAND, INC.
Consolidated Statements of Cash Flows

	Year Ended December 31, 2006	2005	2004
	(In thousands)		
Cash flows from operating activities:			
Net income	$ 7,711	$ 9,569	$ 8,614
Adjustment to reconcile net income to net cash provided by operating activities:			
Depreciation, amortization and accretion	550	2,680	3,656
Provision for loan and lease losses	1,202	1,423	836
Net loss/(gain) on sale of available for sale securities	859	(181)	(90)
Net gain on sales of premises and equipment			(535)
Net gain on other real estate owned		(14)	(2)
Income from bank-owned life insurance	(785)	(691)	(641)
Share-based compensation expense	186	82	35
Tax benefit from exercise of stock options		309	113
(Increase) decrease in accrued interest receivable	210	(1,299)	(69)
(Increase) in prepaid expenses and other assets	(826)	(2,445)	(479)
Increase in other liabilities	1,282	3,623	1,127
Other, net	28	(355)	(101)
Net cash provided by operating activities	10,417	12,701	12,464
Cash flows from investing activities:			
Investment securities available for sale:			
Purchases	(32,990)	(63,520)	(63,982)
Maturities and principal repayments	20,085	13,999	46,000
Proceeds from sales	60,982		10,946
Mortgage-backed securities available for sale:			
Purchases	(51,825)	(142,287)	(107,486)
Maturities and principal repayments	44,460	50,654	47,759
Proceeds from sales	445	13,754	5,572
Net (increase) decrease in loans and leases	(35,047)	7	(14,165)
Purchase of loans and leases, including purchased interest	(17,098)	(65,755)	(58,720)
Purchase of Federal Home Loan Bank of Boston stock	(468)	(2,833)	(3,675)
Capital expenditures for premises and equipment	(2,259)	(5,372)	(2,165)
Proceeds from sale of premises and equipment	1,209		1,206
Proceeds from disposition of other real estate owned		261	2
Purchase of bank-owned life insurance	(3,539)		(2,000)
Net cash used in investing activities	(16,045)	(201,092)	(140,708)
Cash flows from financing activities:			
Net increase in deposits	35,454	100,295	69,391
Net increase (decrease) in overnight and short-term borrowings	30,103	8,188	4,590
Proceeds from long-term borrowings	200,000	333,908	204,155
Repayment of long-term borrowings	(237,775)	(268,713)	(140,981)
Proceeds from issuance of common stock	1,663	22,282	1,266
Tax benefit from exercise of stock options	261		
Dividends on common stock	(2,861)	(2,701)	(2,315)
Net cash provided by financing activities	26,845	193,259	136,106
Net increase (decrease) in cash and cash equivalents	21,217	4,868	7,862
Cash and cash equivalents at beginning of year	40,547	35,679	27,817
Cash and cash equivalents at end of year	$ 61,764	$ 40,547	$ 35,679
Supplementary disclosures:			
Cash paid for interest	$ 36,818	$ 25,137	$ 19,305
Cash paid for income taxes	3,736	5,592	4,729
Non-cash transactions:			
Macrolease acquisition	83	250	
Change in accumulated other comprehensive income, net of taxes	210	(3,882)	(897)

See accompanying notes to consolidated financial statements

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements

(1) Organization

Bancorp Rhode Island, Inc. (the Company), a Rhode Island corporation, is the holding company for Bank Rhode Island (the Bank). The Company has no significant assets other than the common stock of the Bank. For this reason, substantially all of the discussion in these Consolidated Financial Statements and accompanying Notes 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 its customers a wide range 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 Federal Deposit Insurance Corporation (FDIC), subject to regulatory limits. The Bank is also a member of the Federal Home Loan Bank of Boston (FHLB).

(2) Summary of Significant Accounting Policies

Basis of Presentation *The* accounting and reporting policies of the Company conform to U.S. generally accepted accounting principles and to prevailing practices within the banking industry. The Company has one reportable operating segment. The following is a summary of the significant accounting and reporting policies used by management in preparing and presenting the consolidated financial statements.

Use of Estimates *In* preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to change relate to the determination of the allowance for credit losses, review of goodwill for impairment and income taxes.

Principles of Consolidation *At* December 31, 2006 and 2005, the consolidated financial statements include the accounts of Bancorp Rhode Island, Inc., and its wholly-owned subsidiary, Bank Rhode Island, along with the Bank s wholly-owned subsidiaries, BRI Investment Corp. (a Rhode Island passive investment company), BRI Realty Corp. (a Rhode Island real estate holding company), Acorn Insurance Agency, Inc. (a licensed insurance agency) and Macrolease Corporation (an equipment leasing company). All significant intercompany accounts and transactions have been eliminated in consolidation.

Cash and Cash Equivalents For purposes of the consolidated statements of cash flows, the Company considers cash, due from banks, and overnight investments to be cash equivalents. Cash flows relating to deposits are presented net in the statements of cash flows.

Securities Debt securities are classified as available for sale, held to maturity or trading. Securities are classified as held to maturity and carried at amortized cost only if the Company has a positive intent and the ability to hold these securities to maturity. Securities are classified as trading and carried at fair

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

value, with unrealized gains and losses included in earnings, if they are bought and held principally for the purpose of selling in the near term. Securities not classified as either held to maturity or trading are classified as available for sale and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders equity, net of estimated income taxes. As of December 31, 2006 and 2005, all of the Company s investment and mortgage-backed securities were classified as available for sale.

Declines in the fair values of securities below their cost that are deemed to be other-than-temporary are reflected in earnings in the period that management concludes that other-than-temporary impairment occurs. The Company uses various indicators in determining whether a security is other-than-temporarily impaired, including for debt securities, when it is probable that the contractual interest and principal will not be collected.

Interest income from debt securities is recorded on the accrual basis. Premiums and discounts on securities are amortized or accreted into income by the level yield method. Such amortization and accretion is recorded as an adjustment to interest income. FHLB stock is carried at cost. Dividend income from FHLB stock is recorded on the ex-dividend date. Gains and losses on the sale of securities are recognized at the time of sale on a specific identification basis.

Loans and Leases Receivable Loans are stated at the principal amount outstanding, net of unamortized premiums and discounts and net of deferred loan fees and/or costs which are amortized as an adjustment to yield over the life of the related loans. When loans and leases are paid-off, the unamortized portion of premiums, discounts or net fees is recognized into income. Interest income is accrued on a level yield basis over the life of the loan.

Leases which meet the appropriate criteria specified in Statement of Financial Accounting Standard (SFAS) 13, *Accounting for Leases* , are classified as direct finance leases. Direct finance leases are recorded upon acceptance of the equipment by the customer. Unearned lease income represents the excess of the gross lease investment over the cost of the leased equipment, which is recognized over the lease term at a constant rate of return on the net investment in the lease.

Loan and lease origination fees, net of certain direct origination costs, and premiums and discounts on loans purchased are recognized in interest income over the lives of the loans using a method approximating the interest method.

Loans on which the accrual of interest has been discontinued are designated nonaccrual loans. Accrual of interest income is discontinued when concern exists as to the collectibility of principal or interest, or typically when a loan becomes over 90 days delinquent. Additionally, when a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period income. Loans are removed from nonaccrual when they become less than 90 days past due and when concern no longer exists as to the collectibility of principal or interest. Interest collected on nonaccruing loans is either applied against principal or reported as income according to management s judgment as to the collectibility of principal.

Impaired loans are loans for which it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreements. Impairment is measured on a discounted cash flow method, or at the loan s observable market price, or at the fair value of the collateral if the loan is collateral dependent. When foreclosure is probable, impairment is measured based on the fair value of

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

the collateral. In addition, the Bank classifies a loan as an in-substance foreclosure when the Bank is in possession of the collateral prior to actually foreclosing.

Allowance for Credit Losses The allowance for loan and lease losses and reserve for unfunded lending commitments, collectively referred to as the allowance for credit losses, are established for credit losses inherent in the loan and lease portfolio and inherent in the unfunded lending commitments through a charge to earnings. The allowance for credit losses is maintained at a level management considers appropriate to provide for the current inherent risk of loss based upon an evaluation of known and inherent risks in the loan and lease portfolio, as well as the unfunded lending commitments.

When management believes that the collectibility of a loan or lease s principal balance, or portions thereof, is unlikely, the principal amount is charged against the allowance for loan and lease losses. Recoveries on loans and leases that have been previously charged off are credited to the allowance for loan and lease losses as received. Increases to the allowance for loan and leases are made by charges to provision for loan and lease losses.

In addition to the allowance for loan and lease losses, management also estimates probable losses related to unfunded lending commitments. In the third quarter of 2006, the Company reclassified the reserve for unfunded lending commitments from the allowance for loan and lease losses to other liabilities for all periods presented. Additions to the reserve for unfunded lending commitments are made by charges to other expenses.

Management s methodology to estimate loss exposure inherent in the portfolio includes an analysis of individual loans or leases deemed to be impaired, reserve allocations for various loan and lease types based on payment status or loss experience and an unallocated allowance that is maintained based on management s assessment of many factors including, but not limited to, the growth, composition and quality of the loan and lease portfolio, historical loss experience, industry loss experience and general economic conditions. Management employs a similar process with respect to unfunded lending commitments. While management evaluates currently available information in establishing the allowance for loan and lease losses and the reserve for unfunded lending commitments, future adjustments to the allowance for credit losses may be necessary if conditions differ substantially from the assumptions used in making the evaluations. The factors supporting the allowance for loan and lease losses and the reserve for unfunded lending commitments do not diminish the fact that the entire allowance for loan and lease losses and the reserve for unfunded lending commitments are available to absorb losses in the loan portfolio and related commitment portfolio, respectively. The Company s primary concern is the appropriateness of the total allowance for loan and lease losses and reserve for unfunded lending commitments. Management performs a comprehensive review of the allowance for loan and lease losses and the reserve for unfunded lending commitments on a quarterly basis.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution s allowance for credit losses. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Other Real Estate Owned Other Real Estate Owned (OREO) consists of property acquired through foreclosure, real estate acquired through acceptance of a deed in lieu of foreclosure and loans determined to be substantively repossessed. Real estate loans that are substantively repossessed include

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

only those loans for which the Company has taken possession of the collateral, but has not completed legal foreclosure proceedings.

OREO, including real estate substantively repossessed, is stated at the lower of cost or fair value, minus estimated costs to sell, at the date of acquisition or classification to OREO status. Fair value of such assets is determined based on independent appraisals and other relevant factors. Any write-down to fair value at the time of foreclosure is charged to the allowance for loan losses. A valuation allowance is maintained for known specific and potential market declines and for estimated selling expenses. Increases to the valuation allowance, expenses associated with ownership of these properties, and gains and losses from their sale, are reflected in operations as incurred. Realized gains and losses upon disposal are recognized as adjustments to noninterest income or noninterest expense.

Premises and Equipment Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation *and* amortization. Depreciation and amortization are computed primarily by the straight-line method over the estimated useful lives of the assets, or the terms of the leases if shorter.

Impairment of Long-Lived Assets except Goodwill The Company reviews long-lived assets, including premises and equipment and other intangible assets for impairment at least annually or whenever events or changes in business circumstances indicate that the remaining useful life may warrant revision or that the carrying amount of the long-lived asset may not be fully recoverable. The Company performs undiscounted cash flow analyses to determine if impairment exists. If impairment is determined to exist, any related impairment loss is calculated based on fair value. Impairment losses on assets to be disposed of, if any, are based on the estimated proceeds to be received, less any costs of disposal.

Goodwill Goodwill represents the excess of the cost of an acquisition over the fair value of the tangible and identifiable intangible assets acquired. Goodwill is not amortized over an estimated life, but rather is tested at least annually for impairment using market value comparisons. In the event that the Company was to determine that its goodwill was impaired, an impairment writedown would be charged against earnings.

Bank-Owned Life Insurance Bank-owned life insurance (BOLI) represents life insurance on the lives of certain employees who have provided positive consent allowing the Bank to be the beneficiary of such policies. The Bank utilizes BOLI as tax-efficient financing for the Bank s benefit obligations to its employees, including the Bank s obligations under its Supplemental Executive Retirement Plans. Since the Bank is the primary beneficiary of the insurance policies, increases in the cash value of the policies, as well as insurance proceeds received, are recorded in noninterest income, and are not subject to income taxes. BOLI is recorded at the cash value of the policies, less any applicable cash surrender charges, and is reflected as an asset in the accompanying consolidated balance sheets. The Bank reviews the financial strength of the insurance carriers prior to the purchase of BOLI to ensure minimum credit ratings of at least investment grade. The financial strength of the carriers are reviewed at least annually and BOLI with any individual carrier is limited to 10% of capital plus reserves.

Securities Sold Under Agreements to Repurchase The Bank enters into sales of securities under agreements to repurchase, with both the Bank s commercial customers (retail repurchase agreements) and financial institutions (wholesale repurchase agreements). These agreements are treated as financings, and the obligations to repurchase securities sold are reflected as a liability in the consolidated balance sheets. Securities pledged as collateral under agreements to repurchase are reflected as assets in the accompanying consolidated balance sheets.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Employee Benefits The Bank maintains a Section 401(k) savings plan for employees of the Bank and its subsidiaries. Under the plan, the Bank makes a matching contribution of the amount contributed by each participating employee, up to 4% of the employee s yearly salary, subject to Internal Revenue Service (IRS) limits. The Bank s contributions are charged against current operations in the year made.

*Share-*Based *Compensation* At December 31, 2006, the Company maintained stock option plans as described more fully in Note 15. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) 123-R, *Share-Based Payment* , which is a revision to SFAS 123, *Accounting for Stock-Based Compensation* . SFAS 123-R focuses primarily on accounting for share-based payments made to employees. Under SFAS 123-R, the grant date fair value of share-based awards (primarily stock options for the Company) is recognized as an expense in the income statement, whereas under SFAS 123, the Company accounted for share-based awards under the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25).

The Company adopted SFAS 123-R under the modified prospective adoption method. Under that method of adoption, the provisions of SFAS 123-R are generally only applied to share-based awards granted subsequent to adoption and any unvested prior grants. Under SFAS 123-R, share-based awards requiring future service are recognized as compensation expense over the relevant service period or through the eligible retirement date if sooner. Share-based awards that do not require future service (vested awards) are expensed immediately. SFAS 123-R also requires the Company to estimate expected forfeitures in determining compensation expense. Additionally, compensation expense for share-based awards granted to retirement-eligible employees is recognized immediately.

In December 2005, the Executive and Compensation Committees of the Company s Board of Directors accelerated the vesting of all 89,586 unvested stock options. No other changes were made to the terms and conditions of the options. The Company recorded expenses of $49,000 in connection with the accelerated vesting. At the time of the vesting acceleration, approximately 79% of the expenses anticipated to be recorded over the next three years related to stock options that had no intrinsic value, as the stock options were out-of-the-money . Additionally, 73% of the unvested options with a positive intrinsic value, or in-the-money , were scheduled to fully vest by April 30, 2006. As a result of this accelerated vesting, the Company will not be required to recognize anticipated non-cash compensation expense relating to stock options of approximately $370,000 in 2006, $260,000 in 2007 and $70,000 in 2008.

Under SFAS 123, the Company did not recognize compensation expense for stock options issued prior to January 2006 because the stock options had no intrinsic value at grant date, as the exercise price equaled the market value of the Company s common stock on the grant date. The Company did recognize compensation expense related to restricted stock compensation during 2005. The relevant service period for this restricted stock award concluded in December 2005.

As indicated above, at the time of adoption of SFAS 123-R on January 1, 2006, all stock options granted to employees and directors were fully vested and exercisable. As a result, the transition impact of adopting SFAS 123-R was not material to the Company s results of operations for the year ended December 31, 2006.

If the Company had recognized compensation expense for stock options over the relevant service period, generally 3 to 4 years under the fair value method proscribed by SFAS 123, net income would have

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

decreased for the prior two years, resulting in pro forma net income and earnings per common share (EPS) as summarized below:

	Year Ended December 31,	
	2005	2004
Net income (in thousands):		
As reported	$ 9,569	$ 8,614
Compensation cost, net of taxes	(855)	(530)
Pro forma	$ 8,714	$ 8,084
Earnings per common share:		
Basic:		
As reported	$ 2.14	$ 2.17
Compensation cost, net of taxes	(0.19)	(0.14)
Pro forma	$ 1.95	$ 2.03
Diluted:		
As reported	$ 2.04	$ 2.04
Compensation cost, net of taxes	(0.18)	(0.13)
Pro forma	$ 1.86	$ 1.91

The compensation cost, net of taxes, for the year ended 2005 reflects the Company s acceleration of the vesting of all outstanding options as of December 30, 2005.

Income Taxes The Company recognizes income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are established for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expenses during the period that includes the enactment date.

Revenue Recognition Noninterest income is recognized on the accrual basis of accounting.

Comprehensive Income Comprehensive income is defined as all changes to equity except investments by and distributions to shareholders. Net income is a component of comprehensive income, with all other components referred to in the aggregate as other comprehensive income.

Earnings Per Share Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then share in the earnings of the entity.

Segment Reporting An operating segment is defined as a component of a business for which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and evaluate performance. The Company s primary business is banking, which provided substantially all of its total revenues and pre-tax income in 2006, 2005 and 2004. Accordingly, disaggregated segment information is not presented in the notes to the financial statements.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Guarantees FASB Interpretation (FIN) 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* , considers standby letters of credit, excluding commercial letters of credit and other lines of credit, a guarantee of the Bank. The Bank enters into a standby letter of credit to guarantee performance of a customer to a third party. The credit risk involved is represented by the contractual amounts of those instruments. Under the standby letters of credit, the Bank is required to make payments to the beneficiary of the standby letters of credit upon request by the beneficiary so long as all performance criteria have been met. Most guarantees extend up to one year.

Pledged collateral including cash, accounts receivable, inventory, property, plant, equipment and real estate supported all standby letters of credit outstanding at December 31, 2006 and 2005. The collateral obtained is determined based on management s credit evaluation of the customer. Should the Bank be required to make payments to the beneficiary of a letter of credit, repayment to the Bank is required. When cash collateral is present the recourse provisions of the agreements allow the Bank to collect the cash used to collateralize the agreement. If any other business assets are used as collateral and cash is not available, the Bank creates a loan for the customer with the same criteria as its other lending activities. The standby letters of credit and the fair value of customer guarantees and cash collateral supporting the standby letters of credit are not reflected on the balance sheet.

Reclassifications Certain amounts in the prior years financial statements may have been reclassified to conform with the current year s presentation.

Recent Accounting Developments In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140* , which permits, but does not require, fair value accounting for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* . SFAS 155 also eliminated the temporary exemption for interests in securitized financial assets provided for by SFAS 133, Derivatives Implementation Group (DIG) Issue D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets* . However, in January 2007, the FASB issued interpretive guidance in SFAS 133, DIG Issue B40, *Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets* , in which the FASB concluded that a securitized interest in prepayable financial assets was not subject to the bifurcation requirements of SFAS 155 provided that the securitized interest met both the following criteria: (1) the right to accelerate the settlement of the securitized interest cannot be controlled by the investor; and (2) the securitized interest itself does not contain an embedded derivative for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets. The guidance in DIG Issue B40 is effective upon the adoption of SFAS 155. SFAS 155 is effective for all financial instruments acquired or issued after December 31, 2006, as well as to those hybrid financial instruments that had been previously bifurcated under SFAS 133. As of December 31, 2006, the Company did not have any hybrid financial instruments which were previously bifurcated under SFAS 133. Additionally, the guidance provided for in DIG Issue B40 is expected to allow the Company to continue to purchase mortgage-backed securities without applying the bifurcation requirements of SFAS 155. The Company does not anticipate the adoption of SFAS 155 will have a material effect on its financial statements.

In March 2006, the FASB issued SFAS 156, *Accounting for Servicing of Financial Assets* , an amendment of SFAS 140. This standard requires servicing assets and servicing liabilities be initially

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

measured at fair value along with any derivative instruments used to mitigate inherent risks. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The Company does not anticipate SFAS 156 will materially impact its consolidated financial statements upon adoption on January 1, 2007.

In March 2006, the FASB Emerging Issues Task Force (EITF) issued interpretive guidance in Issue 06-4 (EITF 06-4), in which agreements by companies to share a portion of the proceeds of life insurance policies with an employee during the postretirement period is a postretirement benefit arrangement that must be accounted for under SFAS 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* . Under EITF 06-4, the EITF also concluded the purchase of a split-dollar life insurance policy does not constitute a settlement of the postretirement benefit as defined in SFAS 106. Thus, companies will be required to record a liability upon adoption of EITF 06-4, which is effective for periods beginning after December 15, 2007. The Company is currently evaluating the impact EITF 06-4 will have on its consolidated financial statements upon adoption on January 1, 2008.

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS 109, *Accounting for Income Taxes* . FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not anticipate the adoption of FIN 48 will materially impact its consolidated financial statements upon adoption on January 1, 2007.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* . SAB 108 provides guidance regarding the process of quantifying financial statements misstatements and dictates that a company should quantify errors using both a balance sheet approach (the iron curtain method) and an income statement approach (the rollover approach). The balance sheet approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement s year of origination. The income statement method quantifies a misstatement based on the amount of the error originating in the current year income statement, while ignoring the carryover effects of a prior year misstatement. SAB 108 indicates that a company should quantify an error under both methods and by evaluating the materiality under both methods. If deemed material, a company is required to adjust their financial statements. SAB 108 was effective for the first fiscal year ending after November 15, 2006. The Company adopted SAB 108 in the fourth quarter of 2006. SAB 108 did not have a material impact upon adoption.

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), *Fair Value Measurements* . SFAS 157 provides guidance for measuring assets and liabilities at fair value. This standard is applicable whenever other standards require or permit assets and liabilities to be measured at fair value, but does not expand upon the use of fair value in any new circumstances. SFAS 157 establishes a fair value hierarchy that gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires fair value measurements to be disclosed by level within the hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact SFAS 157 will have on its consolidated financial statements upon adoption on January 1, 2008.

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Notes to Consolidated Financial Statements (Continued)

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and to provide additional information that will help investors and other users of financial statements to understand more easily the effect on earnings of the company s choice to use fair value. It also requires companies to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The Company is currently evaluating the impact SFAS 159 will have on its consolidated financial statements upon adoption on January 1, 2008.

(3) Business Combinations

On March 1, 1996, the Bank acquired certain assets and assumed certain liabilities from Fleet Financial Group, Inc. and other 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 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. In connection with this acquisition, the Company has issued 9,040 shares of its common stock, which were valued at $333,000. In addition, 18,082 shares of the Company s common stock may be issued over the next two years contingent upon Macrolease reaching specified performance criteria.

(4) Restrictions on Cash and Due from Banks

The Bank is required to maintain average reserve balances in a noninterest bearing account with the Federal Reserve Bank based upon a percentage of certain deposits. As of December 31, 2006 and 2005, the average daily amount required to be held was $1.0 million and $774,000, respectively.

(5) Investment Securities Available for Sale

The Company categorizes obligations issued by the Federal Home Loan Bank, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association as U.S. Agency obligations. A summary of investment securities available for sale follows:

	Amortized Cost (In thousands)	Unrealized Gains	Losses	Fair Value
At December 31, 2006:				
U.S. Agency obligations	$ 85,992	$ 1	$ (704)	$ 85,289
Corporate debt securities	12,122	7	(105)	12,024
Trust preferred securities	6,152	49	(89)	6,112
Total	$ 104,266	$ 57	$ (898)	$ 103,425
At December 31, 2005:				
U.S. Agency obligations	$ 125,915	$	$ (1,921)	$ 123,994
Corporate debt securities	21,214	57	(608)	20,663
Trust preferred securities	6,199	108	(5)	6,302
Total	$ 153,328	$ 165	$ (2,534)	$ 150,959

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The following table sets forth certain information regarding temporarily impaired investment securities:

	Less than One Year		One Year or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
At December 31, 2006:						
US Agency obligations	$ 29,927	$ (63)	$ 52,361	$ (641)	$ 82,288	$ (704)
Corporate debt securities	3,995	(9)	5,990	(96)	9,985	(105)
Trust preferred securities			1,911	(89)	1,911	(89)
Total	$ 33,922	$ (72)	$ 60,262	$ (826)	$ 94,184	$ (898)
At December 31, 2005:						
US Agency obligations	$ 71,938	$ (1,077)	$ 52,056	$ (844)	$ 123,994	$ (1,921)
Corporate debt securities	10,724	(352)	1,799	(256)	12,523	(608)
Trust preferred securities			1,995	(5)	1,995	(5)
Total	$ 82,662	$ (1,429)	$ 55,850	$ (1,105)	$ 138,512	$ (2,534)

The above securities were deemed to be not other-than-temporarily impaired after considering that substantially all of the above securities were rated investment grade with unrealized losses primarily caused by market interest rate changes. In addition, the Company has the intent and ability to hold all securities with unrealized losses until recovery or maturity.

In making these other-than-temporary impairment determinations, management considers, among other things, the length of time and extent to which the fair value has been less than cost and the credit worthiness and near-term prospects of the issuer. Also, management considers capital adequacy, interest rate risk, liquidity and business plans in assessing the intent and ability to hold all securities with unrealized losses until recovery or maturity.

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Notes to Consolidated Financial Statements (Continued)

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

	Within One Year			After One, But Within Five Years			After Five, But Within Ten Years			After Ten Years		
	Amortized Cost	Fair Value	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield
	(Dollars in thousands)											
At December 31, 2006:												
U.S. Agency obligations	$9,998	$9,959	2.90 %	75,994	$75,330	4.78 %	$	$	0.00 %	$	$	0.00 %
Corporate debt securities	6,037	6,034	5.33 %	6,085	5,990	4.93 %			0.00 %			0.00 %
Trust preferred securities			0.00 %			0.00 %			0.00 %	6,152	6,112	7.63 %
Total	$16,035	$15,993	3.81 %	$82,079	$81,320	4.79 %	$	$	0.00 %	$6,152	$6,112	7.63 %
At December 31, 2005:												
U.S. Agency obligations	$14,992	$14,815	2.81 %	$110,923	$109,179	4.11 %	$	$	0.00 %	$	$	0.00 %
Corporate debt securities	5,047	5,045	4.94 %	16,167	15,618	4.86 %			0.00 %			0.00 %
Trust preferred securities			0.00 %			0.00 %			0.00 %	6,199	6,302	7.34 %
Total	$20,039	$19,860	3.35 %	$127,090	$124,797	4.21 %	$	$	0.00 %	$6,199	$ 6,302	7.34 %

The weighted average remaining life of investment securities available for sale at December 31, 2006 and 2005 was 2.9 years and 2.5 years, respectively. Included in the weighted average remaining life calculation at December 31, 2006 and 2005, were $77.1 million and $84.2 million, respectively, of securities that are callable at the discretion of the issuer. These call dates were not utilized in computing the weighted average remaining life.

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 losses of $859,000 ($852,000 of investment securities and $7,000 of mortgage-backed securities); 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 investment income of over $900,000 by the end of 2007.

The following table presents the sale of investment securities available for sale and the resulting gains and losses from such sales:

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Amortized cost of investment securities sold	$ 61,834	$	$ 10,596
Gains (losses) realized on sales of investment securities	(852)		350
Net proceeds from sales of investment securities	$ 60,982	$	$ 10,946

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

(6) Mortgage-Backed Securities Available for Sale

A summary of mortgage-backed securities available for sale by issuer follows:

	Amortized Cost (In thousands)	Unrealized Gains	Losses	Fair Value
At December 31, 2006:				
Government National Mortgage Association	$ 17,432	$ 15	$ (102)	$ 17,345
Federal National Mortgage Association	109,480	57	(1,645)	107,892
Federal Home Loan Mortgage Corporation	30,411	42	(524)	29,929
Collateralized Mortgage Obligations	86,935	18	(1,657)	85,296
Total	$ 244,258	$ 132	$ (3,928)	$ 240,462
At December 31, 2005:				
Government National Mortgage Association	$ 23,762	$ 160	$ (103)	$ 23,819
Federal National Mortgage Association	113,252	191	(1,062)	112,381
Federal Home Loan Mortgage Corporation	37,528	53	(321)	37,260
Collateralized Mortgage Obligations	62,907		(1,509)	61,398
Total	$ 237,449	$ 404	$ (2,995)	$ 234,858

The following table sets forth certain information regarding temporarily impaired investment securities:

	Less than One Year		One Year or Longer		Total	
	Fair Value (In thousands)	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At December 31, 2006:						
Government National Mortgage Association	$ 4,655	$ (16)	$ 3,123	$ (86)	$ 7,778	$ (102)
Federal National Mortgage Association	25,041	(96)	77,853	(1,549)	102,894	(1,645)
Federal Home Loan Mortgage Corporation	299	(1)	26,603	(523)	26,902	(524)
Collateralized Mortgage Obligations	23,752	(62)	52,051	(1,595)	75,803	(1,657)
Total	$ 53,747	$ (175)	$ 159,630	$ (3,753)	$ 213,377	$ (3,928)
At December 31, 2005:						
Government National Mortgage Association	$ 3,913	$ (52)	$ 6,953	$ (51)	$ 10,866	$ (103)
Federal National Mortgage Association	55,008	(676)	16,225	(386)	71,233	(1,062)
Federal Home Loan Mortgage Corporation	32,901	(317)	412	(4)	33,313	(321)
Collateralized Mortgage Obligations	29,623	(555)	31,775	(954)	61,398	(1,509)
Total	$ 121,445	$ (1,600)	$ 55,365	$ (1,395)	$ 176,810	$ (2,995)

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The above securities were deemed to be not other-than-temporarily impaired after considering that all of the above securities were rated investment grade with unrealized losses caused by market interest rate changes. In addition, the Company is able and intends to hold all securities with unrealized losses until recovery or maturity.

In making these other-than-temporary impairment determinations, management considers, among other things, the length of time and extent to which the fair value has been less than cost and the credit worthiness and near-term prospects of the issuer. Also, management considers capital adequacy, interest rate risk, liquidity and business plans in assessing the intent and ability to hold all securities with unrealized losses until recovery or maturity.

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

	After Five, But Within Ten Years			After Ten Years		
	Amortized Cost	Fair Value	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield
	(Dollars in thousands)					
At December 31, 2006:						
Government National Mortgage Association	$	$		$ 17,432	$ 17,345	4.31 %
Federal National Mortgage Association	15,515	15,136	4.55 %	93,965	92,756	4.94 %
Federal Home Loan Mortgage Corporation				30,411	29,929	4.73 %
Collateralized Mortgage Obligations	2,680	2,604	4.06 %	84,255	82,692	5.01 %
Total	$ 18,195	$ 17,740	4.48 %	$ 226,063	$ 222,722	4.89 %
At December 31, 2005:						
Government National Mortgage Association	$	$		$ 23,762	$ 23,819	4.32 %
Federal National Mortgage Association	18,939	18,613	4.55 %	94,313	93,768	4.69 %
Federal Home Loan Mortgage Corporation				37,528	37,260	4.65 %
Collateralized Mortgage Obligations				62,907	61,398	4.52 %
Total	$ 18,939	$ 18,613	4.55 %	$ 218,510	$ 216,245	4.59 %

Maturities on mortgage-backed securities are based on contractual maturities and do not take into consideration scheduled amortization or prepayments. Actual maturities will differ from contractual maturities due to scheduled amortization and prepayments. The weighted average remaining contractual term of mortgage-backed securities available for sale at December 31, 2006 and 2005 was 20.0 years and 20.2 years, respectively.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

With respect to sales of mortgage-backed securities in 2006, refer to page F-18 for a full description of the investment portfolio restructuring in September 2006. The following table presents the sale of mortgage-backed securities available for sale and the resulting gains and losses from such sales:

	Year Ended December 31,		
	2006	**2005**	**2004**
	(In thousands)		
Amortizedcost of mortgage-backed securities sold	$ 452	$ 13,573	$ 5,832
Gain/(Loss) realized on sales of mortgage-backed securities	(7)	181	(260)
Net proceeds from sales of mortgage-backed securities	$ 445	$ 13,754	$ 5,572

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

(7) Loans and Leases Receivable

The following is a summary of loans and leases receivable:

	December 31, 2006 (In thousands)	2005
Commercial loans and leases:		
Commercial real estate owner occupied	$ 140,812	$ 112,987
Commercial real estate nonowner occupied	102,390	95,779
Commercial and industrial	106,017	73,620
Small business	41,785	38,641
Multi-family	34,294	33,725
Construction	37,237	37,772
Leases and other	62,979	48,745
Subtotal	525,514	441,269
Unearned lease income	(6,651)	(3,366)
Net deferred loan origination costs	927	406
Total commercial loans and leases	519,790	438,309
Residential mortgage loans:		
One- to four-family adjustable rate	165,140	202,223
One- to four-family fixed rate	96,880	101,598
Subtotal	262,020	303,821
Premium on loans acquired	1,979	2,257
Net deferred loan origination fees	(54)	(62)
Total residential mortgage loans	263,945	306,016
Consumer and other loans:		
Home equity term loans	152,484	134,932
Home equity lines of credit	64,208	67,959
Automobile	178	157
Installment	506	365
Savings secured	587	358
Unsecured and other	1,088	1,271
Subtotal	219,051	205,042
Premium on loans acquired		2
Net deferred loan origination costs	1,506	1,437
Total consumer and other loans	220,557	206,481
Total loans and leases receivable	$ 1,004,292	$ 950,806

The Bank s commercial and consumer lending activities are conducted principally in the State of Rhode Island and, to a lesser extent, in nearby areas of Massachusetts. The Bank s equipment lease financing subsidiary, Macrolease, is based in Long Island, NY, with borrowers located throughout the United States. The Bank originates commercial real estate loans, commercial and industrial loans, multi-family residential loans, equipment leases, residential mortgage loans and consumer loans (principally home equity loans and lines of credit) for its portfolio.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The Bank purchases one- to four-family residential mortgage loans and commercial leases from third party originators. These loans and leases may have been originated from areas outside of New England. Most loans made by the Bank are secured by borrowers personal or business assets. The Bank considers a concentration of credit to a particular industry to exist when the aggregate credit exposure to a borrower or group of borrowers in that industry exceeds 25% of the Bank s capital plus reserves. At December 31, 2006, no concentrations of credit to a particular industry existed as defined by these parameters. The ability of the Bank s residential and consumer borrowers to honor their repayment commitments is generally dependent on the level of overall economic activity within the area they reside.

Commercial borrowers ability to repay is generally dependent upon the general health of the economy and in cases of real estate loans, the real estate sector in particular. Accordingly, the ultimate collectibility of a substantial portion of the Bank s loan portfolio is susceptible to changing conditions in the Rhode Island economy in particular, and the New England and Northeast and national economies, in general.

The Bank s lending limit to any single borrowing relationship is limited by law to approximately $18.7 million. At December 31, 2006, the Bank had no outstanding commitments to any single borrowing relationship that were in excess of $10.0 million.

At December 31, 2006, the risk elements contained within the loan portfolio were centered in $1.4 million of nonaccrual loans. There were $476,000 of loans past due 60 to 89 days at December 31, 2006. At December 31, 2006, the Bank had no commitments to lend additional funds to borrowers whose loans were on nonaccrual. This compares to $415,000 of nonaccrual loans and $300,000 of loans past due 60 to 89 days as of December 31, 2005. There are no impaired loans at December 31, 2006, and thus no specific impairment reserves, while included in nonaccrual loans as of December 31, 2005 and 2004, were $141,000 and $671,000 of impaired loans, respectively. At December 31, 2005, specific reserves of $71,000 were maintained against impaired loans compared to $170,000 at December 31, 2004. The average balance of impaired loans was $1.0 million during 2006, $741,000 during 2005 and $1.2 million during 2004.

The reduction in interest income associated with nonaccrual loans was as follows:

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Income in accordance with original terms	$ 99	$ 36	$ 63
Income recognized	(49)	(13)	(34)
Foregone interest income	$ 50	$ 23	$ 29

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Loans outstanding to executive officers and directors of the Company, including their immediate families and affiliated companies (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. These loans comply with the provisions of Regulation O under the Federal Reserve Act and, accordingly, are permissible under Section 402 of the Sarbanes-Oxley Act of 2002. An analysis of the activity of these loans is as follows:

	Year Ended December 31,	
	2006	2005
	(In thousands)	
Balance at beginning of year	$ 5,561	$ 5,019
Additions	525	10,854
Repayments	(672)	(10,312)
Balance at end of year	$ 5,414	$ 5,561

(8) Allowance for Credit Losses

An analysis of the activity in the allowance for credit losses is as follows:

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Allowance for Loan and Lease Losses			
Balance at beginning of year	$ 11,665	$ 11,454	$ 10,690
Provision for loan and lease losses	1,202	1,423	836
Loans charged-off	(519)	(1,274)	(150)
Recoveries of loans previously charged-off	29	62	78
Balance at end of year	12,377	11,665	11,454
Reserve for Unfunded Lending Commitments (1)			
Balance at beginning of year	503	452	388
Provision for unfunded lending commitments	64	51	64
Balance at end of year	567	503	452
Allowance for Credit Losses			
Balance at end of year	$ 12,944	$ 12,168	$ 11,906

(1) In 2006, the Company reclassified the reserve for unfunded lending commitments from the allowance for loan and lease losses to other liabilities for all periods presented.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

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

	December 31, 2006 (In thousands)	2005
Loan category:		
Commercial loans and leases	$ 7,944	$ 7,002
Residential mortgage loans	1,440	1,653
Consumer and other loans	2,086	1,894
Unallocated	907	1,116
Total	$ 12,377	$ 11,665

(9) Premises and Equipment

Premises and equipment consisted of the following:

	December 31, 2006 (In thousands)	2005
Land	$ 1,412	$ 2,620
Office buildings and improvements	2,931	2,631
Leasehold improvements	9,996	8,692
Data processing equipment and software	6,726	6,429
Furniture, fixtures and other equipment	5,808	5,463
Subtotal	26,873	25,835
Less accumulated depreciation and amortization	(13,137)	(10,977)
Total premises and equipment	$ 13,736	$ 14,858

The Company utilizes a useful life of 40 years for buildings and 15 years for building improvements. Leasehold improvements are amortized over their respective lease terms. Data processing equipment and software s useful life varies but is primarily three years. Furniture, fixtures and other equipment s useful life varies but is primarily five years. Depreciation expense totaled $2.2 million, $2.4 million and $2.3 million for the years ended December 31, 2006, 2005 and 2004, respectively.

In November 2004, the Bank sold its South Broadway, East Providence, RI office building, leasing back its branch office space, for a gross selling price of $1.2 million. This transaction generated a total gain of $755,000 from the sale of the premises, $511,000 of which was recognized in 2004 s earnings and $244,000 was deferred, to be recognized over the term of the branch office space lease.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Rent expense for the years ended December 31, 2006, 2005 and 2004 was $1.5 million, $1.3 million and $1.0 million, respectively. In connection with the acquisition of branches from Fleet Financial Group, Inc. and related entities, the Bank assumed the liability for lease payments on seven banking offices previously occupied by Shawmut Bank Connecticut, N.A. The Bank has renegotiated some of these leases and has also entered into agreements to lease additional space. Under the terms of these noncancellable operating leases, the Bank is currently obligated to minimum annual rents as follows:

	Minimum Lease Payments (In thousands)
2007	$ 1,283
2008	1,172
2009	812
2010	509
2011	515
Thereafter	6,758
	$ 11,049

(10) Deposits

Certificate of deposit accounts had the following schedule of maturities:

	December 31, 2006 (In thousands)	2005
1 year or less remaining	$ 358,041	$ 293,053
More than 1 year to 2 years remaining	10,206	36,378
More than 2 years to 3 years remaining	7,965	6,071
More than 3 years to 4 years remaining	4,196	9,020
More than 4 years remaining	1,299	8,527
Total	$ 381,707	$ 353,049

At December 31, 2006, certificate of deposit accounts included $30.0 million obtained through brokers, compared to none at December 31, 2005. At December 31, 2006 and 2005, certificate of deposit accounts with balances of $100,000 or more aggregated $144.3 million and $98.0 million, respectively.

(11) Short-Term Borrowings and Repurchase Agreements

Overnight and short-term borrowings are comprised of the following:

	December 31, 2006 (In thousands)	2005
Treasury tax and loan notes	$ 1,915	$ 2,387
FHLB Ideal Way advances		
Retail repurchase agreements	54,426	23,851
Wholesale repurchase agreements	20,000	20,000
Total	$ 76,341	$ 46,238

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The Bank utilizes the Note Option for remitting Treasury Tax and Loan payments to the Federal Reserve Bank. Under this option the U.S. Treasury invests in obligations of the Bank, as evidenced by open-ended interest-bearing notes. These notes are collateralized by U.S. Agency securities owned by the Bank. Information concerning these treasury tax and loan notes is as follows:

	Year Ended December 31, 2006		2005	
	(Dollars in thousands)			
Outstanding at end of year	$ 1,915		$ 2,387	
Outstanding collateralized by securities with:				
Par value	5,000		5,000	
Market value	4,966		4,897	
Average outstanding for the year	776		739	
Maximum outstanding at any month end	1,915		2,387	
Weighted average rate at end of year	4.26	%	3.95	%
Weighted average rate paid for the year	4.77	%	2.98	%

The Bank has a short-term line of credit with the FHLB. All borrowings from the FHLB are secured by the Bank s stock in the FHLB and a blanket lien on qualified collateral defined principally as 90% of the market value of U.S. Government and Agency obligations and 75% of the carrying value of certain residential mortgage loans. Unused borrowing capacity under this line at December 31, 2006, 2005 and 2004 was $25.0 million, $25.0 million and $15.0 million, respectively.

Information concerning this short-term line of credit is as follows:

	Year Ended December 31, 2006		2005	
	(Dollars in thousands)			
Outstanding at end of year	$		$	
Maturity date	NA		NA	
Average outstanding for the year	$ 616		$ 295	
Maximum outstanding at any month end	3,718		773	
Weighted average rate at end of year	NA		NA	
Weighted average rate paid for the year	5.48	%	3.36	%

The Bank utilizes retail repurchase agreements in connection with a cash management product that the Bank offers its commercial customers and wholesale repurchase agreements with financial institutions. Sales of repurchase agreements are treated as financings. The obligations to repurchase the identical securities that were sold are reflected as liabilities and the securities remain in the asset accounts. All of these agreements are collateralized by U.S. Agency securities owned by the Bank. The securities underlying the agreements were held by the Bank in a special custody account and remained under the Bank s control.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Information concerning retail repurchase agreements is as follows:

	Year Ended December 31, 2006 (Dollars in thousands)		2005	
Outstanding at end of year	$ 54,426		$ 23,851	
Maturity date	1/2/07		1/3/06	
Outstanding collateralized by securities with:				
Par value	$ 103,605		$ 55,769	
Market value	101,807		55,609	
Average outstanding for the year	42,963		22,280	
Maximum outstanding at any month end	54,426		23,851	
Weighted average rate at end of year	5.13	%	3.69	%
Weighted average rate paid for the year	4.78	%	2.80	%

Information concerning wholesale repurchase agreements is as follows:

	Year Ended December 31, 2006 (Dollars in thousands)		2005	
Outstanding at end of year	$ 20,000		$ 20,000	
Maturity date	11/2010 and 6/2011		3/2010 and 11/2010	
Outstanding collateralized by securities with:				
Par value	$ 21,085		$ 22,076	
Market value	20,895		21,946	
Average outstanding for the year	20,000		9,417	
Maximum outstanding at any month end	20,000		20,000	
Weighted average rate at end of year	4.84	%	3.45	%
Weighted average rate paid for the year	4.35	%	2.93	%

Additionally, at December 31, 2006, the Bank had a $3.0 million line of credit with a correspondent bank to facilitate the issuance of letters of credit by the Bank and the conducting of foreign exchange transactions for the Bank s customers. Since inception, there have been no outstanding balances under this line of credit.

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Notes to Consolidated Financial Statements (Continued)

(12) Federal Home Loan Bank of Boston Borrowings

FHLB borrowings are comprised of the following:

	December 31, 2006			December 31, 2005		
	Scheduled Final Maturity	First Call Date (1)	Weighted Average Rate (2)	Scheduled Final Maturity	First Call Date (1)	Weighted Average Rate (2)
	(Dollars in thousands)					
Within 1 year	$ 34,593	$ 153,593	3.57 %	$ 79,250	$ 196,250	3.79 %
Over 1 year to 2 years	27,058	57,058	4.18 %	38,880	38,880	3.60 %
Over 2 years to 3 years	41,331	21,331	4.57 %	30,917	30,917	4.16 %
Over 3 years to 5 years	59,000		4.97 %	63,702	13,702	3.87 %
Over 5 years	80,216	10,216	4.31 %	67,224	224	4.46 %
Total	$ 242,198	$ 242,198	4.40 %	$ 279,973	$ 279,973	3.98 %

(1) Callable FHLB advances of $149 million are shown in the respective periods assuming that the callable debt is redeemed at the next call date while all other advances are shown in the periods corresponding to their scheduled maturity date.

(2) Weighted average rate based on scheduled maturity dates.

All borrowings from the FHLB are secured by the Bank s stock in the FHLB and a blanket lien on qualified collateral defined principally as 90% of the market value of U.S. Government and Agency obligations and 75% of the carrying value of certain residential mortgage loans. Unused term borrowing capacity with the FHLB at December 31, 2006 and 2005 was $40.9 million and $26.9 million, respectively. As one requirement of its borrowings, the Bank is required to invest in the common stock of the FHLB in an amount at least equal to five percent of its outstanding borrowings from the FHLB. As and when such stock is redeemed, the Bank would receive from the FHLB an amount equal to the par value of the stock. As of December 31, 2006 and 2005, the Bank s FHLB stock holdings, recorded at cost, were $16.5 million and $16.1 million, respectively.

(13) Company-Obligated Mandatorily Redeemable Capital Securities and Subordinated Deferrable Interest Debentures

On January 23, 2001, the Company sponsored the creation of BRI Statutory Trust I (the Trust I), a Connecticut statutory trust. The Company is the owner of all of the common securities of Trust I. On February 22, 2001, Trust I issued $3.0 million of its 10.20% Company-Obligated Mandatorily Redeemable Capital Securities (Capital Securities) through a pooled trust preferred securities offering. The proceeds from this issuance, along with the Company s $93,000 capital contribution for Trust I s common securities (which is included in prepaid expenses and other assets), were used to acquire $3.1 million of the Company s 10.20% Subordinated Deferrable Interest Debentures (Junior Subordinated Notes) due February 22, 2031, and constitute the primary asset of Trust I. The Company has, through the Declaration of Trust, the Guarantee Agreement, the Notes and the related Indenture, taken together, fully irrevocably and unconditionally guaranteed all of Trust I s obligations under the Capital Securities, to the extent Trust I has funds available therefor.

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On June 4, 2002, the Company sponsored the creation of BRI Statutory Trust II (the Trust II), a Connecticut statutory trust. The Company is the owner of all of the common securities of Trust II. On June 26, 2002, Trust II issued $5.0 million of its floating rate (quarterly reset to 3 month LIBOR plus 3.45%) Capital Securities through a pooled trust preferred securities offering. At December 31, 2006, the rate of the Capital Securities was 8.82%. The proceeds from this issuance, along with the Company s $155,000 capital contribution for Trust II s common securities (which is included in prepaid expenses and other assets), were used to acquire $5.2 million of the Company s floating rate (quarterly reset to 3 month LIBOR plus 3.45%) Junior Subordinated Notes due June 26, 2032, and constitute the primary asset of Trust II. The Company has, through the Declaration of Trust, the Guarantee Agreement, the Notes and the related Indenture, taken together, fully irrevocably and unconditionally guaranteed all of Trust II s obligations under the Capital Securities, to the extent Trust II has funds available therefor.

On June 5, 2003, the Company sponsored the creation of BRI Statutory Trust III (the Trust III), a Connecticut statutory trust. The Company is the owner of all of the common securities of Trust III. On June 26, 2003, Trust III issued $5.0 million of its 5.55% (quarterly reset to 3 month LIBOR plus 3.10% beginning June 26, 2008) Capital Securities through a pooled trust preferred securities offering. The proceeds from this issuance, along with the Company s $155,000 capital contribution for Trust III s common securities (which is included in prepaid expenses and other assets), were used to acquire $5.2 million of the Company s 5.55% (quarterly reset to 3 month LIBOR plus 3.10% beginning June 26, 2008) Junior Subordinated Notes due June 26, 2033, and constitute the primary asset of Trust III. The Company has, through the Declaration of Trust, the Guarantee Agreement, the Notes and the related Indenture, taken together, fully irrevocably and unconditionally guaranteed all of Trust III s obligations under the Capital Securities, to the extent Trust III has funds available therefor.

On February 24, 2004, the Company sponsored the creation of BRI Statutory Trust IV (the Trust IV), a Connecticut statutory trust. The Company is the owner of all of the common securities of Trust IV. On March 17, 2004, Trust IV issued $5.0 million of its floating rate (quarterly reset to 3 month LIBOR plus 2.79%) Capital Securities through a pooled trust preferred securities offering. At December 31, 2006, the rate of the Capital Securities was 8.15%. The proceeds from this issuance, along with the Company s $155,000 capital contribution for Trust IV s common securities (which is included in prepaid expenses and other assets), were used to acquire $5.2 million of the Company s floating rate (quarterly reset to 3 month LIBOR plus 2.79%) Junior Subordinated Notes due March 17, 2034, and constitute the primary asset of Trust IV. The Company has, through the Declaration of Trust, the Guarantee Agreement, the Notes and the related Indenture, taken together, fully irrevocably and unconditionally guaranteed all of Trust IV s obligations under the Capital Securities, to the extent Trust IV has funds available therefor.

As of December 31, 2006, the Company s investments in its statutory trust subsidiaries aggregated $649,000 and are included within prepaid expenses and other assets.

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(14) Income Taxes

The components of income tax expense are as follows:

	Year Ended December 31, 2006 (In thousands)	2005	2004
Current expense:			
Federal	$ 5,056	$ 4,763	$ 4,873
State	51	92	66
Total current expense	5,107	4,855	4,939
Deferred benefit:			
Federal	(1,531)	(15)	(643)
State			
Total deferred benefit	(1,531)	(15)	(643)
Total income tax expense	$ 3,576	$ 4,840	$ 4,296

The difference between the statutory federal income tax rate and the effective federal income tax rate is as follows:

	2006	2005	2004
Statutory federal income tax rate	35.0 %	35.0 %	35.0 %
Increase resulting from:			
State income tax, net of federal tax benefit	0.3	0.4	0.3
Bank-owned life insurance	(2.4)	(1.7)	(1.7)
Other, net	(1.2)	(0.1)	(0.3)
Effective combined federal and state income tax rate	31.7 %	33.6 %	33.3 %

The significant components of gross deferred tax assets and gross deferred tax liabilities are as follows:

	December 31, 2006 (In thousands)	2005
Gross deferred tax assets:		
Allowance for loan and lease losses	$ 4,348	$ 4,103
Securities available for sale	1,623	1,736
Depreciation	1,299	479
Accrued retirement	785	632
Loss on investments	273	
Other	579	193
Total gross deferred tax assets	8,907	7,143
Gross deferred tax liabilities:		
Goodwill	(2,556)	(2,210)
Net deferred tax asset	$ 6,351	$ 4,933

The net balance of deferred tax assets and liabilities is included in prepaid expenses and other assets. It is management s belief that it is more likely than not that the reversal of deferred tax liabilities and

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

results of future operations will generate sufficient taxable income to realize the deferred tax assets. In addition, the Company s net deferred tax asset is supported by recoverable income taxes. Therefore, no valuation allowance was deemed necessary at December 31, 2006 or 2005. It should be noted, however, that factors beyond management s control, such as the general state of the economy and real estate values, can affect future levels of taxable income and that no assurance can be given that sufficient taxable income will be generated to fully absorb gross deductible temporary differences.

(15) Employee and Director Benefits

Employee 401(k) Plan *The* Bank maintains a 401(k) Plan (the Plan) which qualifies as a tax exempt plan and trust under Sections 401 and 501 of the Internal Revenue Code. Generally, Bank employees who are at least twenty-one (21) years of age are eligible to participate in the Plan. Expenses associated with the Plan were $450,000, $388,000 and $352,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Nonqualified Deferred Compensation Plan *The* Bank also maintains a Nonqualified Deferred Compensation Plan (the Nonqualified Plan) under which certain participants may contribute the amounts they are precluded from contributing to the Bank s 401(k) Plan because of the qualified plan limitations, and additional compensation deferrals that may be advantageous for personal income tax or other planning reasons. Expenses associated with the Nonqualified Plan were $40,000, $43,000 and $39,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Accrued liabilities associated with the Nonqualified Plan were $644,000 and $770,000 for December 31, 2006 and 2005, respectively.

Supplemental Executive Retirement Plans *The* Bank maintains Supplemental Executive Retirement Plans (the SERPs) for certain of its senior executives under which participants designated by the Board of Directors are entitled to an annual retirement benefit. Expenses associated with the SERPs were $436,000, $578,000 and $391,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Accrued liabilities associated with the SERPs were $2.2 million and $1.8 million for December 31, 2006 and 2005, respectively.

Restricted Stock Agreement *During 2*001, the Company entered into a Restricted Stock Agreement with its CEO, pursuant to which she was awarded 7,700 shares of restricted stock, subject to achievement of certain performance goals spanning a three year period, which have been achieved. The restricted shares vested 50% on January 1, 2005 and 50% on January 1, 2006. The restricted shares were subject to forfeiture in the event of termination of the CEO s employment prior to the applicable vesting dates for cause by the Company or without good reason by the executive. In addition, the Company made a gross-up payment sufficient to pay any taxes of the CEO (including those on the gross-up payment) arising as a result of the vesting of the restricted stock. The relevant service period for this restricted stock concluded in December 2005. Expenses associated with the Restricted Stock Agreement were $97,000 and $129,000 for the years ended December 31, 2005 and 2004, respectively.

Employee Stock Plans *The* Company maintains a 1996 Incentive and Nonqualified Stock Option Plan and a 2002 Equity Incentive Plan (collectively the Employee Stock Plans) under which it may grant awards of its common stock to officers and key employees. The 1996 Incentive and Nonqualified Stock Option Plan has no remaining shares available for issuance as it expired in March 2006. At December 31, 2006, the total remaining shares available for issuance under the 2002 Equity Incentive Plan is 142,383. The 2002 Equity Incentive Plan also provides for automatic incremental increases each year in the number of shares authorized for issuance under such plan on the date of the annual shareholders meeting equal to

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Notes to Consolidated Financial Statements (Continued)

the least of (i) 2% of total issued and outstanding common stock on the date of the shareholders meeting, (ii) 75,000 shares and (iii) such lesser number as determined by the Board of Directors of the Company. The Employee Stock Plans, which are shareholder approved, allow grants of options, restricted stock, stock appreciation rights (SARs), performance shares or units and other stock-based awards. To date, the Company has only awarded options under the Employee Stock Plans, which have been granted at an exercise price equal to the market value of the stock on the date of the grant with vesting terms of three to five years. Unless exercised, options granted under the Employee Stock Plans have a 10-year contractual term. Certain stock option awards provide for accelerated vesting if there is a change in control (as defined in the Employee Stock Plans).

The fair value of each employee stock option award has been estimated on the grant date using the Black-Scholes option-pricing model utilizing the following pricing assumptions, summarized on a weighted-average basis in the table below:

	Year Ended December 31,		
	2006	2005	2004
Expected term	7 years	7 years	7 years
Expected volatility	23 %	25 %	25 %
Risk-free interest rate	4.73 %	3.90 %	3.73 %
Dividend yield	1.71 %	1.70 %	1.66 %
Fair value of options granted	$ 10.01	$ 9.27	$ 9.38

The activity related to these employee stock options is summarized below:

Employee Stock Options	Options Outstanding	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Contractual Term (in years)
Outstanding, December 31, 2003	399,538	$ 14.65		
Granted	106,650	$ 33.79		
Exercised	(53,308)	$ 13.70		
Forfeited/Canceled	(7,575)	$ 23.21		
Outstanding, December 31, 2004	445,305	$ 19.21		
Granted	68,000	$ 37.05		
Exercised	(73,374)	$ 18.29		
Forfeited/Canceled	(10,951)	$ 33.18		
Outstanding, December 31, 2005	428,980	$ 21.27		
Granted	60,850	$ 35.18		
Exercised	(74,059)	$ 18.57		
Forfeited/Canceled	(12,750)	$ 33.26		
Outstanding, December 31, 2006	403,021	$ 24.57	$ 7,527,000	5.8
Exercisable, December 31, 2006	342,171	$ 22.69	$ 7,036,000	5.2

The total intrinsic value of options by employees exercised during 2006, 2005 and 2004 was $1.3 million, $1.6 million and $1.1 million, respectively.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The options outstanding as of December 31, 2006 are set forth below:

Exercise Price	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (in years)
$10.00 $19.99	161,171	$ 12.56	2.8
20.00 29.99	51,700	$ 23.09	6.0
30.00 39.99	187,650	$ 35.03	8.3
40.00 49.99	2,500	$ 44.93	9.8
Outstanding, December 31, 2006	403,021	$ 24.57	5.8

The following table summarizes share-based compensation and the related tax benefit for the periods indicated:

	Year Ended December 31, 2006	2005	2004
	(in thousands)		
Share-based compensation(1)	$ 97	$ 146	$ 129
Excess tax benefit related to share-based compensation(2)	244	309	104

(1) Expenses for 2005 and 2004 include expenses relating to the Restricted Stock Agreement, as described on page F-32, for which the relevant service period concluded in December 2005.

(2) Represents the tax benefits on stock options exercised and share-based compensation.

As of December 31, 2006, there was $455,000 of total unrecognized compensation cost related to nonvested employee compensation arrangements. This cost is expected to be recognized over a weighted average period of 3.9 years.

Director Stock Plan The Company established a Non-Employee Director Stock Plan (the Director Stock Plan) under which it may grant up to 90,000 options to acquire its Common Stock to non-employee directors. At December 31, 2006, the total remaining shares available for issuance under the Director Stock Plan is 19,000. Each non-employee director elected at the 1998 shareholders meeting received an option for 1,500 shares and each new non-employee director elected subsequently receives an option for 1,000 shares. Non-employee directors also receive an annual option grant for 500 shares as of the date of each annual meeting of shareholders. Options are granted at an exercise price equal to the market value of the stock on the date of the grant and vest six months after the grant date. Options granted under the Director Stock Plan have a 10-year contractual term, subject to earlier of expiration on the second anniversary of a director s termination of service.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The fair value of each non-employee director stock option award has been estimated on the grant date using the Black-Scholes option-pricing model utilizing the following pricing assumptions, summarized on a weighted-average basis in the table below:

	Year Ended December 31, 2006	2005	2004
Expected term	8 years	7 years	7 years
Expected volatility	28 %	25 %	25 %
Risk-free interest rate	5.05 %	3.83 %	4.25 %
Dividend yield	1.66 %	1.58 %	1.66 %
Fair value of options granted	$ 12.73	$ 10.89	$ 9.76

The activity related to these director stock options is summarized below:

Employee Stock Options	Options Outstanding	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Contractual Term (in years)
Outstanding, December 31, 2003	37,000	$ 17.82		
Granted	7,000	$ 33.43		
Exercised	(1,500)	$ 22.60		
Forfeited/Canceled				
Outstanding, December 31, 2004	42,500	$ 20.22		
Granted	7,000	$ 38.07		
Exercised				
Forfeited/Canceled				
Outstanding, December 31, 2005	49,500	$ 22.75		
Granted	8,000	$ 36.19		
Exercised	(4,000)	$ 30.15		
Forfeited/Canceled	(500)	$ 35.24		
Outstanding, December 31, 2006	53,000	$ 24.09	$ 1,015,000	5.1
Exercisable, December 31, 2006	52,000	$ 23.73	$ 1,015,000	5.0

The total intrinsic value of options exercised by directors during 2006, 2005 and 2004 was $49,000, $0 and $25,000, respectively.

The director options outstanding as of December 31, 2006 are set forth below:

Exercise Price	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (in years)
$10.00 $19.99	25,000	$15.32	2.8
20.00 29.99	9,500	$24.03	5.6
30.00 39.99	17,500	$35.59	8.0
40.00 49.99	1,000	$42.85	9.8
Outstanding, December 31, 2006	53,000	$24.09	5.1

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The following table summarizes share-based compensation and the related tax benefit for the periods indicated:

	Year Ended December 31,		
	2006	2005	2004
	(in thousands)		
Share-based compensation	$ 89	$	$
Excess tax benefit related to share-based compensation(1)	17		9

(1) Represents the tax benefits on stock options exercised and share-based compensation.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

As of December 31, 2006, there was $7,000 of total unrecognized compensation cost related to nonvested director compensation arrangements. This cost is expected to be recognized over the next three months.

Change of Control Agreements *The* Bank has entered into Employment Agreements with its President and Chief Executive Officer, Chief Financial Officer, Chief Operating Officer and Chief Business Officer. These agreements generally provide for the continued payment of specified compensation and benefits for the remainder of the term of the agreement upon termination without cause. The agreements also provide that if the executive is terminated (or in the case of the Chief Executive Officer, resigns) in conjunction with a Change in Control, they are entitled to a severance payment, which is equal to 2.99 times base salary plus target bonus for the President and Chief Executive Officer and 2.00 times base salary plus target bonus for the Chief Financial Officer, Chief Operating Officer, and Chief Business Officer. Except in the case of the Chief Operating Officer, payments under the employment agreements following a Change in Control are subject to the golden parachute excise tax, the Company will make a gross-up payment sufficient to ensure that the net after-tax amount retained by the executive (taking into account all taxes, including those on the gross-up payment) is the same as if such excise tax had not applied.

(16) Other Expenses

Major components of other expenses are as follows:

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Postage and mailing	$ 603	$ 566	$ 582
Forms and supplies	560	583	578
Telephone	538	584	507
Director fees	434	346	241
Credit card and interchange fees	266	289	323
Charitable contributions	231	246	268
Insurance	227	207	221
Correspondent bank fees	155	154	202
Recruiting	63	130	176
Other	1,992	1,522	1,069
Total	$ 5,069	$ 4,627	$ 4,167

In December 2006, the Company recorded insurance recovery proceeds of $803,000 relating to a loss the Company incurred in the first quarter of 2006 of $868,000. These amounts are recorded net within other expenses in the table above and on the Consolidated Statement of Operations for the year ended December 31, 2006.

(17) Commitments and Contingent Liabilities

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to originate loans and letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with off-balance sheet risk are summarized as follows:

	December 31, 2006 (In thousands)	2005
Commitments to originate or purchase loans and leases	$ 35,250	$ 37,623
Unused lines of credit and other commitments	205,673	177,317
Letters of credit	3,353	1,895

Commitments to originate loans and unused lines of credit are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since certain commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management s credit evaluation of the borrower.

Letters of credit are conditional commitments issued by the Bank to guarantee the performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. At December 31, 2006 and 2005, the maximum potential amount of future payments under letters of credit was $3.2 million and $1.5 million, respectively. At December 31, 2006 and 2005, cash collateral supported $1.1 million and $1.0 million, respectively, of the outstanding standby letters of credit. The fair value of the guarantees was $24,000 and $11,000, respectively, and is not reflected on the balance sheet.

(18) Fair Value of Financial Instruments

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS 107, *Disclosures About Fair Value of Financial Instruments* . The estimated fair value amounts have been determined by using available quoted market information or other appropriate valuation methodologies. The aggregate fair value amounts presented are in accordance with SFAS 107 guidelines but do not represent the underlying value of the Bank taken as a whole.

The fair value estimates provided are made at a specific point in time, based on relevant market information and the characteristics of the financial instrument. The estimates do not provide for any premiums or discounts that could result from concentrations of ownership of a financial instrument. Because no active market exists for some of the Bank s financial instruments, certain fair value estimates are based on subjective judgments regarding current economic conditions, risk characteristics of the financial instruments, future expected loss experience, prepayment assumptions and other factors. The resulting estimates involve uncertainties and therefore cannot be determined with precision. Changes made to any of the underlying assumptions could significantly affect the estimates.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

The book values and estimated fair values for the Company s financial instruments are as follows:

	December 31, 2006 Book Value (In thousands)	Estimated Fair Value	December 31, 2005 Book Value (In thousands)	Estimated Fair Value
Assets:				
Cash and due from banks	$ 24,469	$ 24,469	$ 30,177	$ 30,177
Overnight investments	37,295	37,295	10,370	10,370
Investment securities	103,425	103,425	150,959	150,959
Mortgage-backed securities	240,462	240,462	234,858	234,858
Stock in the FHLB	16,530	16,530	16,062	16,062
Loans and leases receivable, net of allowance for loan and lease losses:				
Commercial loans and leases	511,218	509,636	430,337	429,892
Residential mortgage loans	262,391	262,158	304,197	292,703
Consumer and other loans	218,306	216,418	204,104	204,524
Accrued interest receivable	6,755	6,755	6,965	6,965
Liabilities:				
Deposits:				
Demand deposit accounts	$ 200,282	$ 200,282	$ 185,089	$ 185,089
NOW accounts	70,736	70,736	89,594	89,594
Money market accounts	6,991	6,991	12,122	12,122
Savings accounts	356,707	356,707	341,115	341,115
Certificate of deposit accounts	381,707	382,403	353,049	353,755
Overnight and short-term borrowings	56,341	56,341	26,238	26,238
Wholesale repurchase agreements	20,000	20,151	20,000	20,014
FHLB borrowings	242,198	242,918	279,973	280,009
Subordinated deferrable interest debentures	18,558	18,708	18,558	20,564
Accrued interest payable	5,084	5,084	2,928	2,928

Cash and due from banks *The* carrying values reported in the balance sheet for cash and due from banks approximate the fair values because of the short maturity of these instruments.

Overnight investments *The* carrying values reported in the balance sheet for federal funds sold and overnight investments approximate the fair values because of the short maturity of these instruments.

Investment and mortgage-backed securities *The* fair values presented for investment and mortgage-backed securities are based on quoted bid prices received from securities dealers.

Stock in the Federal Home Loan Bank of Boston *The* fair value of stock in the FHLB equals the carrying value reported in the balance sheet. This stock is redeemable at full par value only by the FHLB.

Loans and leases receivable *Fair* value estimates are based on loans and leases with similar financial characteristics. Loans and leases have been segregated by homogenous groups into residential mortgage, commercial, and consumer and other loans. Fair values are estimated by discounting contractual cash flows, adjusted for prepayment estimates, using discount rates approximately equal to current market rates

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

on loans with similar characteristics and maturities. The incremental credit risk for nonperforming loans has been considered in the determination of the fair value of loans.

Deposits The fair values reported for demand deposit, NOW, money market, and savings accounts are equal to their respective book values reported on the balance sheet. The fair values disclosed are, by definition, equal to the amount payable on demand at the reporting date. The fair values reported for certificate of deposit accounts are based on the discounted value of contractual cash flows. The discount rates used are representative of approximate rates currently offered on certificate of deposit accounts with similar remaining maturities.

Overnight and short-term borrowings The carrying values reported in the balance sheet for overnight and short-term borrowings approximate the fair values because of the short maturity of these instruments.

Wholesale repurchase agreements The fair values reported for wholesale repurchase agreements are based on the discounted value of contractual cash flows. The discount rates used are representative of approximate rates currently offered on borrowings with similar remaining maturities.

Federal Home Loan Bank of Boston borrowings The fair values reported for FHLB borrowings are based on the discounted value of contractual cash flows. The discount rates used are representative of approximate rates currently offered on borrowings with similar remaining maturities.

Subordinated deferrable interest debentures The fair values reported for Subordinated deferrable interest debentures are based on the discounted value of contractual cash flows. The discount rates used are representative of approximate rates currently offered on instruments with similar terms and remaining maturities.

Accrued interest receivable and payable The carrying values for accrued interest receivable and payable approximate fair values because of the short-term nature of these financial instruments.

Financial instruments with off-balance sheet risk Since the Bank s commitments to originate or purchase loans, and for unused lines and outstanding letters of credit, are primarily at market interest rates, there is no significant fair value adjustment.

(19) Shareholders Equity

Capital guidelines issued by the Federal Reserve Board (FRB) require the Company to maintain minimum capital levels for capital adequacy purposes. Tier I capital is defined as common equity and retained earnings, less certain intangibles. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance-sheet items to one of four risk categories, each with an appropriate weight. The risk-based capital rules are designed to make regulatory capital more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. The Bank is also subject to FDIC regulations regarding capital requirements. These regulations require banks to maintain minimum capital levels for capital adequacy purposes and higher capital levels to be considered well capitalized .

As of December 31, 2006 and 2005, the Company and the Bank met all applicable minimum capital requirements and were considered well capitalized by both the FRB and the FDIC. There have been no events or conditions since the end of the year that management believes would cause a change in either the

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Company s or the Bank s categorization. The Company s and the Bank s actual and required capital amounts and ratios are as follows:

	Actual		For Capital Adequacy Purposes		To Be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
At December 31, 2006:						
Bancorp Rhode Island, Inc.:						
Tier I capital (to average assets)	$ 121,782	8.37 %	$ 43,658	3.00 %	$ 72,763	5.00 %
Tier I capital (to risk-weighted assets)	121,782	12.05 %	40,428	4.00 %	60,642	6.00 %
Total capital (to risk-weighted assets)	134,159	13.27 %	80,856	8.00 %	101,070	10.00 %
Bank Rhode Island:						
Tier I capital (to average assets)	$ 104,213	7.18 %	$ 43,540	3.00 %	$ 72,567	5.00 %
Tier I capital (to risk-weighted assets)	104,213	10.32 %	40,405	4.00 %	60,607	6.00 %
Total capital (to risk-weighted assets)	116,590	11.54 %	80,809	8.00 %	101,011	10.00 %
At December 31, 2005:						
Bancorp Rhode Island, Inc.:						
Tier I capital (to average assets)	$ 114,822	8.21 %	$ 41,933	3.00 %	$ 69,889	5.00 %
Tier I capital (to risk-weighted assets)	114,822	12.62 %	36,394	4.00 %	54,592	6.00 %
Total capital (to risk-weighted assets)	126,200	13.87 %	72,789	8.00 %	90,986	10.00 %
Bank Rhode Island:						
Tier I capital (to average assets)	$ 93,339	6.67 %	$ 41,965	3.00 %	$ 69,941	5.00 %
Tier I capital (to risk-weighted assets)	93,339	10.26 %	36,378	4.00 %	54,566	6.00 %
Total capital (to risk-weighted assets)	104,717	11.51 %	72,755	8.00 %	90,944	10.00 %

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

(20) Earnings Per Share

The following table is a reconciliation of basic EPS and diluted EPS:

	Year Ended December 31, 2006	2005	2004
Basic EPS Computation:			
Numerator:			
Net income (in thousands)	$ 7,711	$ 9,569	$ 8,614
Denominator:			
Weighted average shares outstanding	4,766,854	4,478,081	3,975,413
Basic EPS	$ 1.62	$ 2.14	$ 2.17
Diluted EPS Computation:			
Numerator:			
Net income (in thousands)	$ 7,711	$ 9,569	$ 8,614
Denominator:			
Common shares outstanding	4,766,854	4,478,081	3,975,413
Stock options	153,715	214,174	238,281
Restricted stock		3,372	6,199
Contingent shares		1,507	
Warrants			2,963
Total shares	4,920,569	4,697,134	4,222,856
Diluted EPS	$ 1.57	$ 2.04	$ 2.04

(21) Regulation and Litigation

The Company and the Bank are subject to extensive regulation and examination by the FRB, the Rhode Island Division of Banking and the FDIC, which insures the Bank s deposits to the maximum extent permitted by law. The federal and state laws and regulations which are applicable to banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds and the nature and amount of and collateral for certain loans. The laws and regulations governing the Bank generally have been promulgated to protect depositors and not for the purpose of protecting shareholders. Among other things, bank regulatory authorities have the right to restrict the payment of dividends by banks and bank holding companies to shareholders.

The Company is involved in routine legal proceedings occurring in the ordinary course of business. In the opinion of management, final disposition of these lawsuits will not have a material adverse effect on the consolidated financial condition or results of operations of the Company.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

(22) Parent Company Statements

The following are condensed financial statements for Bancorp Rhode Island, Inc. (the Parent Company):

Balance Sheets

	December 31, 2006 (In thousands)	2005
Assets		
Assets:		
Cash and due from banks	$	$ 20
Overnight investments	17,120	21,237
Investment in subsidiaries	113,165	101,973
Prepaid expenses and other assets	437	381
Total assets	$ 130,722	$ 123,611
Liabilities and Shareholders Equity		
Liabilities:		
Subordinated deferrable interest debentures	$ 18,558	$ 18,558
Other liabilities	79	221
Total liabilities	18,637	18,779
Shareholders equity:		
Preferred stock: par value $0.01 per share, authorized 1,000,000 shares. Issued and outstanding: none		
Common stock: par value $0.01 per share, authorized 11,000,000 shares. Issued and outstanding: 4,792,380 shares at December 31, 2006 and 4,719,126 shares in December 31, 2005	48	47
Additional paid-in capital	67,960	65,768
Retained earnings	47,091	42,241
Accumulated other comprehensive loss, net	(3,014)	(3,224)
Total shareholders equity	112,085	104,832
Total liabilities and shareholders equity	$ 130,722	$ 123,611

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Statements of Operations

	Year Ended December 31,		
	2006	**2005**	**2004**
	(In thousands, except per share data)		
Income:			
Dividends received from subsidiaries	$ 700	$ 3,750	$ 3,500
Interest on overnight investments	945	486	30
Total income	1,645	4,236	3,530
Expenses:			
Interest on notes payable	1,460	1,272	1,041
Compensation expense	98	97	130
Directors fees	261	118	103
Professional services	550	253	254
Other expenses	3	1	1
Total expenses	2,372	1,741	1,529
Income (loss) before income taxes	(727)	2,495	2,001
Income tax expense (benefit)	(540)	(423)	(504)
Income (loss) before equity in undistributed earnings of subsidiaries	(187)	2,918	2,505
Equity in undistributed earnings of subsidiaries	7,898	6,651	6,109
Net income	$ 7,711	$ 9,569	$ 8,614

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

Statements of Cash Flow

	Year Ended December 31, 2006 (In thousands)	2005	2004
Cash flows from operating activities:			
Net income	$ 7,711	$ 9,569	$ 8,614
Adjustment to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	(7,898)	(6,651)	(6,109)
Share-based compensation expense	186	82	35
Tax benefit from stock option exercises		309	113
(Increase) decrease in other assets	(56)	107	(91)
Increase (decrease) in other liabilities	(142)	8	110
Other, net	(1)		1
Net cash provided by operating activities	(200)	3,424	2,673
Cash flows from financing activities:			
Proceeds from notes payable			5,155
Investment in subsidiaries	(3,000)	(5,250)	(5,155)
Proceeds from issuance of common stock	1,663	22,532	1,266
Tax benefit from stock option exercises	261		
Dividends on common stock	(2,861)	(2,701)	(2,315)
Net cash used by financing activities	(3,937)	14,581	(1,049)
Net increase (decrease) in cash and due from banks	(4,137)	18,005	1,624
Cash and cash equivalents at beginning of year	21,257	3,252	1,628
Cash and cash equivalents at end of year	$ 17,120	$ 21,257	$ 3,252
Supplementary disclosures:			
Cash paid (received) for income taxes	$ (1,011)	$ (542)	$ (508)
Non-cash transactions:			
Change in other comprehensive income, net of taxes	210	(3,882)	(897)

The Parent Company s Statements of Changes in Shareholders Equity is identical to the Consolidated Statements of Changes in Shareholders Equity and therefore is not presented here.

BANCORP RHODE ISLAND, INC.
Notes to Consolidated Financial Statements (Continued)

(23) Quarterly Results of Operations (unaudited)

	2006 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Interest and dividend income	$ 19,395	$ 19,762	$ 21,017	$ 21,028
Interest expense	8,345	9,433	10,341	10,855
Net interest income	11,050	10,329	10,676	10,173
Provision for loan and lease losses	267	435	400	100
Net interest income after provision for loan and lease losses	10,783	9,894	10,276	10,073
Noninterest income	2,305	2,815	1,544	2,324
Noninterest expense	10,824	9,725	9,504	8,674
Income before taxes	2,264	2,984	2,316	3,723
Income taxes	739	978	673	1,186
Net income	$ 1,525	$ 2,006	$ 1,643	$ 2,537
Basic EPS	$ 0.32	$ 0.42	$ 0.34	$ 0.53
Diluted EPS	$ 0.31	$ 0.41	$ 0.33	$ 0.51

	2005 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Interest and dividend income	$ 15,745	$ 17,068	$ 17,862	$ 18,845
Interest expense	5,374	6,298	7,095	7,852
Net interest income	10,371	10,770	10,767	10,993
Provision for loan and lease losses	300	354	415	377
Net interest income after provision for loan and lease losses	10,071	10,416	10,352	10,616
Noninterest income	2,075	2,445	2,581	2,173
Noninterest expense	8,512	9,125	9,156	9,527
Income before taxes	3,634	3,736	3,777	3,262
Income taxes	1,227	1,276	1,310	1,027
Net income	$ 2,407	$ 2,460	$ 2,467	$ 2,235
Basic EPS	$ 0.60	$ 0.55	$ 0.53	$ 0.47
Diluted EPS	$ 0.57	$ 0.52	$ 0.50	$ 0.46