

BANCORP RHODE ISLAND INC

Form 10-K

February 23, 2005

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

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## FORM 10-K

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

For the fiscal year ended December 31, 2004

Commission File No. 001-16101

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# BANCORP RHODE ISLAND, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

**05-0509802**  
(IRS Employer  
Identification No.)

**ONE TURKS HEAD PLACE, PROVIDENCE, RI 02903**

(Address of Principal Executive Offices)

**(401) 456-5000**

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(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)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

As of June 30, 2004, the aggregate market value of the voting common equity of the Registrant held by non-affiliates of the Registrant, based on the closing price on The Nasdaq Stock Market was \$106,024,000.

As of February 18, 2005, there were 4,010,929 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 2005 Annual Meeting of Shareholders is incorporated by reference into Parts II and III of this 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 including the branch expansion plan;

statements regarding the quality of our products and our loan and investment portfolios; and

estimates of our risks and future costs and benefits.

These forward looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following important factors that could affect the actual outcome of future events:

significantly increased competition among depository and other financial institutions;

changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;

general economic conditions, either nationally or in our market area, that are worse than expected;

adverse changes in the securities markets;

credit risk of lending activities, including changes in the level and trend of loan delinquencies and write-offs;

changes in management's estimate of the adequacy of the allowance for loan and lease losses;

the ability to successfully integrate new branches into our branch footprint;

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legislative or regulatory changes that adversely affect our business;

the ability to enter new markets successfully and capitalize on growth opportunities;

effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board;

timely and efficient development of and acceptance of new products and services;

changes in consumer spending, borrowing and savings habits;

effects of changes in accounting policies and practices, as may be adopted by the bank regulatory agencies and other regulatory and accounting bodies;

changes in our organization, compensation and benefit plans;

costs and effects of litigation and unexpected or adverse outcomes in such litigation; and

our success in managing risks involved in the foregoing.

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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 from time to time in 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 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. (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 14 full-service branches, with nine located in Providence County, four located in Kent County and one located in Washington County. The Bank augments its branch network through online banking services and automatic teller machines ( ATMs ), both owned and leased, located throughout Rhode Island.

The Bank provides a community banking alternative in the greater Providence market which is dominated by three large banking institutions, one national and two regional. Based on total deposits as of June 30, 2004 (excluding one bank that draws its deposits primarily from the internet), the Bank is the fifth largest bank in Rhode Island and the only mid-sized commercially focused bank headquartered in Providence, the state's capital. The Bank offers a wide variety of commercial real estate, business, residential and consumer loans, deposit products, nondeposit investment products, cash management and online banking services, and other banking products and services, designed to meet the financial needs of individuals and small- to mid-sized businesses. As a full-service community bank, the Bank seeks to differentiate itself from its large bank competitors through superior personal service, responsiveness and local decision-making. The Bank's deposits are insured by the FDIC, subject to regulatory limits.

The Bank's principal subsidiary, 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>.



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### **Lending Activities**

**General.** The Bank's business strategy has been to grow its commercial and consumer loan portfolios while allowing its residential mortgage loan portfolio to decline gradually (as a percent of total loans) as the Bank is able to replace residential mortgage loans with higher yielding commercial and consumer loans. The Bank has allocated substantial resources to its commercial and consumer lending functions to facilitate and promote such growth. From December 31, 1999, until December 31, 2004, commercial loan and lease outstandings have increased \$228.2 million, or 130.8%, and consumer loan outstandings have increased \$120.3 million, or 255.5%. This growth represents compound annual growth rates (CAGR) of 18.2% and 28.9%, respectively. As a result, commercial loans and leases increased from 38.0% of total loans and leases at December 31, 1999, to 45.4% of total loans and leases at December 31, 2004, and consumer and other loans increased from 10.3% of total loans and leases at December 31, 1999, to 18.9% of total loans and leases at December 31, 2004. Meanwhile, residential mortgage loans decreased from 51.7% of total loans and leases at December 31, 1999, to 35.7% of total loans and leases at December 31, 2004.

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 72% of Rhode Island businesses are located in Providence and Kent Counties. More than 95% of these businesses have fewer than 50 employees. The Bank believes the financing needs of these businesses generally match the Bank's lending profile and that the Bank's branches are well positioned to facilitate the generation of loans from this customer base.

The Bank's commercial lending function is organized into three groups. The commercial real estate group originates nonowner-occupied commercial real estate, multi-family residential real estate and construction loans. The business lending group originates owner-occupied commercial real estate loans, term loans and revolving lines of credit, in addition to purchasing leases from third-party originators. The small business group originates a variety of real estate and non-real estate loans for business lending relationships of approximately \$250,000 or less.

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

The Bank has tiered lending authorities. Loan commitments up to \$1.0 million per customer relationship may be approved by Department Heads of the Bank's Business Lending, Commercial Real Estate and Retail Lending departments. All extensions of credit of more than \$1.0 million (up to the Bank's house lending limit of \$7.0 million) per customer relationship requires 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 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, 2004, the Bank had \$179.7 million of aggregate loan commitments outstanding to fund a variety of loans.

Overall, loans and leases produced total interest income of \$47.1 million, or 81.6% of total interest and dividend income, in 2004 and \$42.5 million, or 82.0% of total interest and dividend income, during 2003.



***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, 2004, owner-occupied commercial real estate loans totaled \$93.0 million, or 10.5% of the total loan portfolio. Many of these customers have other commercial borrowing relationships with the Bank, as the Bank finances

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their other business needs. Generally these customer relationships are handled in the Bank's business lending group. Nonowner-occupied commercial real estate loans totaled \$90.7 million, or 10.2% of the total loan portfolio, and multi-family residential loans totaled \$32.4 million, or 3.7% of the total loan portfolio, and are generally handled in the Bank's commercial real estate group. The majority of real estate secured commercial loans are originated on a five-year adjustable rate basis. Interest rates typically charged on these loans are higher than those charged on adjustable rate loans secured by one- to four-family residential units. Additionally, origination fees may be charged on these loans.

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

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

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

At December 31, 2004, commercial and industrial loans totaled \$78.9 million, or 8.9% of the total loan portfolio. Generally, commercial and industrial loans have relatively shorter maturities than residential and commercial real estate loans, or are at adjustable rates without interest rate caps. Unlike residential and commercial real estate loans, which generally are based on the borrower's ability to make repayment from employment and rental income and which are secured by real property whose value tends to be relatively easily ascertainable, commercial and industrial loans are typically made on the basis of the borrower's ability to make repayment from the cash flow of the business and are generally secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial and industrial loans may be significantly dependent on the success of the business itself. Further, the collateral securing the loans may be difficult to value, fluctuate in value based on the success of the business and deteriorate over time.

**Leases.** From time to time, the Bank purchases equipment leases from third party originators. At December 31, 2004, leases totaled \$38.1 million, or 4.3% of the total loan and lease portfolio. These leases have short-term maturities of five years or less and are generally structured to achieve payment in full over the term of the lease, so that, absent default, they are not dependent on residual collateral values. The U.S. Government and its agencies are the principal lessees on over 90% of these leases. The remaining lessees are generally not-for-profits or small businesses. The Company anticipates expanding its leasing portfolio in the future.

**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



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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, 2004, small business loans totaled \$37.8 million, or 4.3% of the total loan portfolio. Generally, small business loans are granted at higher rates than commercial and industrial loans. These loans have relatively short-term maturities or are at adjustable rates without interest rate caps.

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

**Construction Loans.** The Bank originates residential construction loans to individuals and professional builders to construct one- to four-family residential units, either as primary residences or for resale. The Bank also makes construction loans for the purpose of constructing multi-family or commercial properties. At December 31, 2004, outstanding construction loans totaled \$32.3 million, or 3.6% of the total loan portfolio. Currently, the Bank offers interest-only construction loans during the construction period.

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

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

**Residential Mortgage Loans.** The Bank's one- to four-family residential mortgage loan portfolio consists primarily of whole loans purchased from other financial institutions. Currently, the Bank purchases fixed- and adjustable-rate (ARM) mortgage whole loans from other financial institutions both in New England and elsewhere in the country. The Bank anticipates continuing to purchase residential mortgage loans until such time as its commercial and consumer loan originations are sufficient to utilize available cash flows. 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, 2004, approximately 27% of the residential mortgage loan portfolio consisted of loans secured by real estate outside of New England.

Additionally, but to a lesser extent, the Bank originates ARMs for its own portfolio. The Bank also originates fixed rate mortgage loans and generally sells these mortgages to its correspondents at the time of the loan's closing. While the Bank anticipates that its residential mortgage loan portfolio will decline long-term as it focuses its resources on commercial and consumer lending, the Bank plans to continue its own origination of one- to four-family residential mortgage loans, primarily in its market area. Such activity would decrease the Bank's need to purchase residential mortgage loans in order to enhance profitability while it increases its commercial and consumer loan portfolios, as well as

facilitate overall growth of customer relationships.

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At December 31, 2004, one- to four-family residential mortgage loans totaled \$316.1 million, or 35.7% of the total loan portfolio. The fixed rate portion of this portfolio totaled \$115.4 million and had original maturities of 15 to 30 years. The adjustable rate portion of this portfolio totaled \$199.0 million and generally had original maturities of 30 years. Interest rates on adjustable rate loans are set for an initial period of either 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, 2004, the consumer loan portfolio totaled \$167.4 million, or 18.9% 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. During 2000 and 2001, the Bank purchased automobile loans from another New England institution. At December 31, 2004, purchased automobile loans totaled \$488,000, or 0.1% of the total loan portfolio.

## **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 U.S. agency securities, mortgage-backed securities ( MBSs ), collateralized mortgage obligations ( CMOs ), corporate debt securities, Federal Home Loan Bank of Boston ( FHLB ) stock and overnight investments, represents \$291.9 million, or 23.6% of total assets, as of December 31, 2004. 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 Executive Vice President Finance 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. During 2003 and 2004, the Company retained the services of an outside investment advisory firm to provide interest-rate risk management services and to assist in the management of the investment portfolio. With the recent addition of the Bank's Executive Vice President Finance and Treasurer, the Company discontinued the services of this firm effective January 1, 2005.

Overall, investments produced total interest and dividend income of \$10.6 million, or 18.4% of total interest and dividend income, in 2004 and \$9.3 million, or 18.0% of total interest and dividend income, during 2003.

## **Deposits**

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

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retain deposits. The Bank emphasizes retail deposits obtained locally in contrast to wholesale deposits obtained from national or regional deposit brokers.

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, namely its checking and savings accounts. As a by-product of the Bank's continuing emphasis on checking account growth, service charges on deposit accounts (which include insufficient funds ( NSF ) fees) have also grown over the years and represent the largest source of noninterest income for the Company. Service charges on deposit accounts increased \$599,000, or 15.3%, from \$3.9 million for 2003, to \$4.5 million for 2004, primarily as a result of changes in the Bank's NSF fee assessment methodology, along with growth in debit card usage, which more than offset a decline in base service charges.

Historically, the Bank's emphasis on core accounts has led to relatively modest CD balance growth. At December 31, 1999, CD balances aggregated \$228.4 million, compared with \$248.5 million at December 31, 2004. With the recent rise in interest rates, consumers have been more willing to extend maturities and the Bank has offered competitively priced CDs. While the Bank prices CDs competitively, and from time to time will run special offers, the Bank historically has not solicited high cost CDs, but instead has emphasized core deposit gathering.

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 overall earnings and growth goals. The Pricing Committee analyzes the cost of funds and also reviews the pricing of deposit related fees and charges.

The Bank also derives funds from loan repayments, sales of investment securities, and FHLB and other borrowings. Loan repayments and deposit inflows and outflows are significantly influenced by prevailing interest rates, competition and general economic conditions. Borrowings may be used on a short-term basis to compensate for reductions in normal sources of funds, or on a longer-term basis to support expanded lending activities.

## **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, 2004, 2003 and 2002 were \$973,000, \$875,000 and \$978,000, respectively.

## **Employees**



At December 31, 2004, the Company had 224 full-time and 53 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.

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### **Competition and Marketplace**

The Company's primary operating subsidiary, the Bank, is headquartered in Providence, Rhode Island, and operates in Rhode Island and nearby areas of Massachusetts. The Bank faces significant competition both in making loans and generating deposits. The Bank's most significant competition comes from three large banks, one national and two regional, that have dominated the Rhode Island market. These three large institutions control approximately 84% of the deposits (based upon June 2004 FDIC statistics, excluding one bank that draws its deposits primarily from the internet) in Providence and Kent Counties, the Bank's primary marketplace. These large banks have well-established, deeper distribution networks and greater financial resources than the Bank, 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. In addition, the Bank faces competition for loans from local banks and out-of-state financial institutions that 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 corporation and government securities funds and other non-bank financial institutions such as brokerage firms, insurance companies and credit unions, the latter of which, following a devastating series of closures and bankruptcies in the early 1990's, are currently experiencing a resurgence in the State of Rhode Island. Many of the Bank's non-bank competitors are not subject to the same degree of regulation as that imposed on federally insured state chartered banks or benefit from tax advantages not available to the Company. As a result, such non-bank competitors have advantages over the Bank in providing certain services.

The population in the Bank's market area is growing slowly and economic growth in the Rhode Island area has been slow to moderate over the past several years, lagging behind other parts of the United States. Accordingly, the Bank's future growth depends largely upon its ability to increase its market penetration in existing markets and expand into new markets. Moreover, economic conditions beyond the Bank's control may have a significant impact on the Bank's operations. Examples of such conditions include the strength of credit demand by customers and changes in the general levels of interest rates. Furthermore, the Bank's commercial and consumer lending activities are conducted principally in Rhode Island and, to a lesser extent, Southeastern Massachusetts. Its borrowers' ability to honor their repayment commitments is generally dependent upon the level of economic activity and general health of the regional economy, and any economic recession in the Bank's market area could cause significant increases in nonperforming assets, thereby reducing operating profits, impairing liquidity and eroding capital.

### **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.

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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

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Securities Exchange Act of 1934, as amended (the Exchange Act ), and the Sarbanes-Oxley Act of 2002. New SEC rules which became effective in late August 2004, accelerate reporting of numerous internal events which will increase 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***

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

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increased civil and/or criminal penalties upon financial institutions and the individuals who manage or control such institutions.

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

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

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

The FDIC has established a risk-based bank assessment system the rates of which are determined on the basis of a particular institution's supervisory rating and capital level. The assessment system is based upon three supervisory categories and three capital categories, resulting in risk-based premiums which range from the current 0 basis points (subject to a \$2,000 minimum annual fee) for the most highly-rated, well-capitalized banks to 27 basis points per \$100 of domestic deposits for troubled banks which are undercapitalized (as discussed below). The Bank currently pays the minimum assessment.

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

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

In addition, the FDIC has adopted capital guidelines based upon ratios of a bank's capital to total assets adjusted for risk, which require FDIC-insured banks to maintain a total capital-to-risk weighted assets ratio ( Risk-Based Capital Ratio ) of at least 8.0% and a Tier 1 Risk-Based Capital Ratio of at least 4.0%. The guidelines provide a general framework for assigning assets and off-balance sheet items (such as standby letters of credit) to broad risk categories and provide procedures for the calculation of the Risk-Based Capital Ratio. Tier 1 (sometimes referred to as core ) capital consists of common shareholders' equity, qualifying, non-



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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, 2004, the Bank's Tier 1 leverage ratio was 6.78%, its total Risk-Based Capital Ratio was 10.86% and its Tier 1 Risk-Based Capital Ratio was 9.61%. Based upon the above ratios, the Bank is considered well capitalized for regulatory capital purposes.

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

The FDIC has broad powers to take prompt corrective action to resolve problems of insured depository institutions, depending upon a particular institution's level of capital. For example, a bank which does not meet applicable minimum capital requirements or is deemed to be in a troubled condition may be subject to additional restrictions, including a requirement of written notice to federal regulatory authorities prior to certain proposed changes in senior management or directors of the institution. Undercapitalized, significantly undercapitalized and critically undercapitalized institutions also are subject to a number of other requirements and restrictions.

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

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

### ***Federal Supervision: FRB***



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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.

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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, 2004, on a consolidated basis, the Company's Tier 1 Leverage Ratio was 7.06%, its total Risk-Based Capital Ratio was 11.26% and its Tier 1 Risk-Based Capital Ratio was 10.01%. 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 \$5.0 million at December 31, 2004 and \$10.2 million at December 31, 2003. 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



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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-B-L 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 new 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.

To date the G-L-B Act has not had a significant impact on the Bank's day-to-day operations. 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

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is public. In connection with the filing of an application to conduct certain transactions, the CRA performance record of the banks involved are reviewed. Under the Bank's last CRA examination, the Bank received a Satisfactory rating.

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

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

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

*Check 21.* The Check Clearing for the 21<sup>st</sup> Century Act, or Check 21 as it is commonly known, became effective October 28, 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 intends to utilize the Check 21 authority and expects to incur additional costs for technology necessary to process check information electronically.

*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*

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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

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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 2. PROPERTIES**

The Bank presently has a network of 14 branch offices located in Providence, Kent and Washington Counties. Seven of these branch office facilities are owned and seven 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 adequate to meet the banking needs of the Bank's customers.

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

<u>Location</u>	<u>Size (Square feet)</u>	<u>Year Opened or Acquired</u>	<u>Owned or Leased</u>	<u>Lease Expiration Date</u>
<i>Branch offices:</i>				
1047 Park Avenue, Cranston, RI	4,700	1996	Owned	N.A.
383 Atwood Avenue, Cranston, RI	4,700	1996	Owned	N.A.
2104 Plainfield Pike, Cranston, RI	700	2002	Owned	N.A.
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
Ten Rod Road, North Kingstown, RI	4,000	2004	Land Leased	6/30/19
One Turks Head Place, Providence, RI	5,000	1996	Leased	4/30/09
165 Pitman Street, Providence, RI	3,300	1998	Leased	10/18/08
445 Putnam Pike, Smithfield, RI	3,500	1996	Leased	7/31/09
1062 Centerville Road, Warwick, RI	2,600	1996	Owned	N.A.
1300 Warwick Avenue, Warwick, RI	4,200	1996	Leased	6/30/09
2975 West Shore Road, Warwick, RI	3,500	2000	Leased	3/31/10
1175 Cumberland Hill Road, Woonsocket, RI	3,100	1998	Owned	N.A.
<i>Administrative and operational offices:</i>				
625 G. Washington Highway, Lincoln, RI	14,600	2003	Leased	12/31/12
One Turks Head Place, Providence, RI	20,600	1999	Leased	6/30/09
<i>Planned branch offices:</i>				
625 G. Washington Highway, Lincoln, RI	(A)	NA	Leased	12/31/12
1269 South County Trail, East Greenwich, RI	(A)	NA	Leased	5/31/25
499 Smithfield Avenue, Pawtucket, RI	(A)	NA	Leased	7/31/20

(A) Facility currently under construction or in planning.

**ITEM 3. LEGAL PROCEEDINGS**



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

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

There were no matters submitted to a vote of security holders in the fourth quarter of 2004.

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

Bancorp Rhode Island, Inc.'s common stock is traded on the Nasdaq Stock Market® under the symbol BARI. The following table sets forth certain information regarding the Common Stock for the periods indicated.

	Stock Price		Dividend Paid
	High	Low	
2003:			
First Quarter	\$ 23.50	\$ 20.65	\$ 0.14
Second Quarter	26.80	21.60	0.14
Third Quarter	29.00	21.49	0.14
Fourth Quarter	33.40	28.00	0.14
2004:			
First Quarter	\$ 33.70	\$ 31.46	\$ 0.14
Second Quarter	35.97	32.45	0.14
Third Quarter	36.65	34.00	0.15
Fourth Quarter	40.71	35.20	0.15

As of February 18, 2005, there were approximately 1,400 holders of record of the Common Stock.

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The following table represents selected consolidated financial data as of and for the years ended December 31, 2004, 2003, 2002, 2001 and 2000. The selected consolidated financial data is derived from the Company's Consolidated Financial Statements, which have been audited by KPMG LLP. The selected consolidated financial data set forth below does not purport to be complete and should be read in conjunction with, and are qualified in their entirety by, the more detailed information, including the Consolidated Financial Statements and related Notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, appearing elsewhere herein.

	As of and for the year ended December 31,				
	2004	2003	2002 <sup>(a)</sup>	2001	2000
	(Dollars in thousands, except Per Share Data)				
Statement of operations data:					
Interest income	\$ 57,719	\$ 51,773	\$ 53,507	\$ 55,903	\$ 50,035
Interest expense	19,625	19,453	22,180	26,537	23,678
Net interest income	38,094	32,320	31,327	29,366	26,357
Provision for loan and lease losses	900	1,600	1,875	1,669	1,542
Noninterest income	8,581	8,830	7,083	5,231	3,578
Noninterest expense	32,865	28,790	25,024	23,196	19,662
Income before taxes	12,910	10,760	11,511	9,732	8,731
Income taxes	4,296	3,546	3,849	3,417	3,113
Net income	\$ 8,614	\$ 7,214	\$ 7,662	\$ 6,315	\$ 5,618
Per share data:					
Basic earnings per common share	\$ 2.17	\$ 1.89	\$ 2.04	\$ 1.69	\$ 1.51
Diluted earnings per common share	\$ 2.04	\$ 1.77	\$ 1.92	\$ 1.62	\$ 1.49
Dividends per common share	\$ 0.58	\$ 0.56	\$ 0.53	\$ 0.48	\$ 0.42
Dividend pay-out ratio	28.4%	31.6%	27.6%	29.6%	28.2%
Book value per common share	\$ 19.68	\$ 18.53	\$ 17.59	\$ 15.74	\$ 14.29
Tangible book value per common share	\$ 16.99	\$ 15.76	\$ 14.73	\$ 12.88	\$ 11.09
Average common shares outstanding Basic	3,975,413	3,819,232	3,758,214	3,730,910	3,728,688
Average common shares outstanding Diluted	4,222,856	4,085,878	3,996,670	3,900,028	3,768,589
Balance sheet data:					
Total assets	\$ 1,239,069	\$ 1,093,971	\$ 1,012,877	\$ 862,250	\$ 739,420
Investment securities	104,600	98,595	101,329	49,453	47,296
Mortgage-backed securities	159,946	106,618	156,114	150,650	117,431
Total loans and leases receivable	886,301	814,282	670,658	610,964	518,825
Allowance for loan and lease losses	11,906	11,078	10,096	8,524	7,294
Goodwill, net	10,766	10,766	10,766	10,766	11,930
Deposits	880,674	811,283	761,911	670,413	631,632
Borrowings	271,386	203,622	179,305	129,398	51,889
Common shareholders' equity	78,923	72,107	66,427	59,097	53,292
Total shareholders' equity	78,923	72,107	66,427	59,097	53,292
Average balance sheet data:					
Total assets	\$ 1,168,036	\$ 1,046,741	\$ 947,205	\$ 818,905	\$ 679,085
Investment securities	102,827	91,153	71,481	49,881	47,034



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	As of and for the year ended December 31,				
	2004	2003	2002 <sup>(a)</sup>	2001	2000
	(Dollars in thousands, except Per Share Data)				
Mortgage-backed securities	132,946	123,524	177,753	130,342	86,114
Total loans and leases receivable	848,550	747,174	622,545	584,400	491,327
Allowance for loan and lease losses	11,490	10,739	9,375	8,056	6,472
Goodwill, net	10,766	10,766	10,766	11,373	12,540
Deposits	858,739	779,540	706,338	644,795	572,924
Borrowings	227,365	192,068	174,668	115,677	54,471
Common shareholders' equity	74,704	69,010	61,922	56,101	48,530
Total shareholders' equity	74,704	69,010	61,922	56,101	48,530
Operating ratios:					
Interest rate spread	3.07%	2.91%	3.04%	3.12%	3.44%
Net interest margin	3.44%	3.28%	3.48%	3.75%	4.10%
Efficiency ratio (b)	70.41%	69.96%	65.15%	67.05%	65.68%
Return on average assets (c)	0.74%	0.69%	0.81%	0.77%	0.83%
Return on average equity (c)	11.53%	10.45%	12.37%	11.26%	11.58%
Asset quality ratios:					
Nonperforming loans to total loans	0.08%	0.30%	0.11%	0.12%	0.10%
Nonperforming assets to total assets	0.06%	0.23%	0.08%	0.12%	0.07%
Allowance for loan and lease losses to nonperforming loans	1,624.28%	449.96%	1,371.74%	1,132.01%	1,435.83%
Allowance for loan and lease losses to total loans	1.34%	1.36%	1.51%	1.40%	1.41%
Net loans charged-off to average loans outstanding	0.01%	0.08%	0.05%	0.08%	(0.01)%
Capital ratios:					
Average shareholders' equity to average total assets	6.40%	6.59%	6.54%	6.85%	7.15%
Tier I leverage ratio	7.06%	6.76%	6.19%	5.93%	5.91%
Tier I risk-based capital ratio	10.01%	9.71%	9.63%	9.86%	9.50%
Total risk-based capital ratio	11.26%	10.92%	10.88%	11.10%	10.76%

- (a) Earnings for 2002 and subsequent years were positively impacted by the Company's adoption of Statement of Financial Accounting Standards (SFAS) 142, *Goodwill and Other Intangible Assets* and SFAS 147, *Acquisitions of Certain Financial Institutions*. These Statements required the Company to cease amortizing its goodwill and begin reviewing it at least annually for impairment. In prior years, the amount of this amortization was \$1.2 million annually. Also see discussion under *Recent Accounting Developments*.
- (b) Calculated by dividing total noninterest expenses by net interest income plus noninterest income.
- (c) Excludes cumulative effect of change in accounting principle, net of taxes.

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

#### **Introduction**

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

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

#### **Overview**

The Company's operating results depend primarily on two factors: its net interest income and the quality of its assets.

The Company's net interest income is the difference between its interest income and its cost of money. Interest income depends on the amount of interest-earning assets outstanding during the year and the interest rates earned thereon. Cost of money is a function of the average amount of deposits and borrowed money outstanding during the year and the interest rates paid thereon. See discussion under *Results of Operations Net Interest Income*. 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 that are not being paid on a timely basis and exhibit other weaknesses can result in the loss of principal and/or loss of interest income. Additionally, the Company must make timely provisions to its allowance for loan and lease losses as a result of its estimates as to potential future losses; these additions, which are charged against earnings, are necessarily greater when greater potential losses are expected. Finally, the Company will incur expenses as a result of resolving troubled assets. All of these form the credit risk that the Company takes on in the ordinary course of its business and is further discussed under *Financial Condition Asset Quality*.

The Company's business strategy has been to concentrate its asset generation efforts on commercial and consumer loans and its deposit generation efforts on checking and savings accounts. These deposit accounts are commonly referred to as core deposit accounts. This strategy is based on the Company's belief that it can distinguish itself from its larger competitors, and indeed attract customers from them, through a higher

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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

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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 promote business opportunities presented by its customer base, franchise footprint and system resources through increased efforts in the area of consumer lending and to a lesser degree, residential mortgage originations.

The deposit market in Rhode Island is highly concentrated. The State's three largest banks have an aggregate market share of 84% (based upon June 2004 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 intensified during the past year. With Bank of America entering New England for the first time earlier this year, numerous institutions in the market have heightened their advertising and promotional product offerings.

Currently, approximately 80% of the Company's total revenues (defined as net interest income plus noninterest income) are derived from its level of net interest income. In an effort to diversify its sources of revenue, the Company has attempted to expand its sources of noninterest income, primarily fees and charges for products and services it offers. The Company has increased its percentage of noninterest income to total revenue from 12.0% in 2000, to 18.4% in 2004, by emphasizing core deposit growth which generates increased service charges, and by introducing additional financial services, such as nondeposit investment products.

Future operating results will depend on the Company's ability to maintain and expand its net interest margin, while minimizing its exposure to credit risk, along with increasing its sources of noninterest income, while controlling the growth of its noninterest or operating expenses.

## **Critical Accounting Policies**

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

### *Allowance for loan and lease losses*

Arriving at an appropriate level of allowance for loan and lease losses necessarily involves a significant degree of judgment. First and foremost in arriving at an appropriate allowance is the creation and maintenance of a risk rating system that accurately classifies all loans and leases into varying categories by degree of credit risk. Such a system also establishes a level of allowance associated with each category of loans and requires early identification and reclassification of deteriorating credits. Besides numerous subjective judgments as to the number of categories, appropriate level of allowance with respect to each category and judgments as to categorization of any individual loan or lease, additional subjective judgments are involved when ascertaining the probability as well as the extent of any potential losses. The Company's ongoing evaluation process includes a formal analysis of the allowance each quarter, which considers, among other factors, the character and size of the loan portfolio, business and economic conditions, loan growth, delinquency trends, nonperforming loan trends, charge-off experience and other asset quality factors. These factors are based on observable information, as well as subjective assessment and interpretation. Nonperforming



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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

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expected future cash flows, and where available, the observable market price of the loans. Provisions for losses on the remaining commercial, commercial real estate, small business, residential mortgage and consumer loans and leases are based on pools of similar loans or leases using a combination of payment status, historical loss experience, industry loss experience, market economic factors, delinquency rates and qualitative adjustments. Management uses available information to establish the allowance for loan and lease losses at the level it believes is appropriate. However, future additions to the allowance may be necessary based on changes in estimates or assumptions resulting from changes in economic conditions and other factors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan and lease losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments about information available to them at the time of their examination.

*Review of goodwill for impairment*

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

**Table of Contents****Results of Operations***Net Interest Income*

Net interest income for 2004 was \$38.1 million, compared to \$32.3 million for 2003 and \$31.3 million for 2002. This increase of \$5.8 million, or 17.9%, during 2004 was primarily attributable to the continued growth of the Company. The Company's net interest margin increased in 2004 to 3.44%, compared to 3.28% in 2003. In 2002, the net interest margin was 3.48%. Average earning assets increased \$120.9 million, or 12.3%, and average interest-bearing liabilities increased \$87.0 million, or 10.5%, during 2004, compared to 2003.

*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,**

	<b>2004</b>			<b>2003</b>			<b>2002</b>		
	<b>Average balance</b>	<b>Interest earned/paid</b>	<b>Average yield</b>	<b>Average balance</b>	<b>Interest earned/paid</b>	<b>Average yield</b>	<b>Average balance</b>	<b>Interest earned/paid</b>	<b>Average yield</b>
<b>(Dollars in thousands)</b>									
<b>Assets</b>									
<b>Earning assets:</b>									
Overnight investments	\$ 12,286	\$ 138	1.12%	\$ 15,993	\$ 170	1.06%	\$ 19,840	\$ 313	1.58%
Investment securities	102,827	4,452	4.33%	91,153	3,999	4.39%	71,481	3,375	4.72%
Mortgage-backed securities	132,946	5,709	4.29%	123,524	4,886	3.96%	177,753	8,428	4.74%
Stock in the FHLB	10,811	308	2.85%	8,633	262	3.03%	7,528	277	3.68%
<b>Loans receivable:</b>									
Commercial loans and leases	369,263	23,092	6.25%	309,105	19,494	6.31%	259,673	18,396	7.08%
Residential mortgage loans	337,825	17,087	5.06%	334,754	17,677	5.28%	293,117	18,646	6.36%
Consumer and other loans	141,462	6,933	4.90%	103,315	5,285	5.12%	69,755	4,072	5.84%
<b>Total earning assets</b>	<b>1,107,420</b>	<b>57,719</b>	<b>5.21%</b>	<b>986,477</b>	<b>51,773</b>	<b>5.25%</b>	<b>899,147</b>	<b>53,507</b>	<b>5.95%</b>
Cash and due from banks	23,170			24,902			20,434		
Allowance for loan and lease losses	(11,490)			(10,739)			(9,375)		
Premises and equipment	12,709			11,732			7,878		
Goodwill, net	10,766			10,766			10,766		
Accrued interest receivable	4,584			4,554			4,599		
Bank-owned life insurance	16,026			15,175			10,340		
Prepaid expenses and other assets	4,851			3,874			3,416		
<b>Total assets</b>	<b>\$ 1,168,036</b>			<b>\$ 1,046,741</b>			<b>\$ 947,205</b>		

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<b>Liabilities and Shareholders Equity</b>									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 123,064	1,172	0.95%	\$ 114,767	1,363	1.19%	\$ 65,466	705	1.08%
Money market accounts	16,315	213	1.31%	11,587	121	1.04%	10,114	130	1.29%
Savings accounts	325,019	3,899	1.20%	301,667	4,043	1.34%	275,263	5,083	1.85%
Certificate of deposit accounts	225,381	5,638	2.50%	210,081	5,916	2.82%	235,822	8,118	3.44%
Overnight and short-term borrowings	16,643	157	0.94%	18,324	140	0.76%	23,118	322	1.39%
FHLB borrowings	193,234	7,505	3.88%	163,155	7,185	4.40%	145,961	7,377	5.05%
Subordinated deferrable interest debentures	17,487	1,041	5.95%			0.00%			0.00%
Capital trust and other subordinated securities			0.00%	10,589	685	6.47%	5,589	445	7.96%
<b>Total interest-bearing liabilities</b>	<b>917,143</b>	<b>19,625</b>	<b>2.14%</b>	<b>830,170</b>	<b>19,453</b>	<b>2.34%</b>	<b>761,333</b>	<b>22,180</b>	<b>2.91%</b>
Noninterest-bearing deposits	168,960			141,438			119,673		
Other liabilities	7,229			6,123			4,277		
<b>Total liabilities</b>	<b>1,093,332</b>			<b>977,731</b>			<b>885,283</b>		
Shareholders equity	74,704			69,010			61,922		
<b>Total liabilities and shareholders equity</b>	<b>\$ 1,168,036</b>			<b>\$ 1,046,741</b>			<b>\$ 947,205</b>		
<b>Net interest income</b>		<b>\$ 38,094</b>			<b>\$ 32,320</b>			<b>\$ 31,327</b>	
Net interest rate spread			3.07%			2.91%			3.04%
Net interest rate margin			3.44%			3.28%			3.48%

**Table of Contents***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,					
	2004 vs. 2003			2003 vs. 2002		
	Increase/(decrease) due to			Increase/(decrease) due to		
	Rate	Volume	Total	Rate	Volume	Total
(In thousands)						
Interest income:						
Overnight investments	\$ 10	\$ (42)	\$ (32)	\$ (89)	\$ (54)	\$ (143)
Investment securities	(53)	506	453	(253)	877	624
Mortgage-backed securities	435	388	823	(1,247)	(2,295)	(3,542)
Stock in the FHLB	(17)	63	46	(53)	38	(15)
Commercial loans and leases	(165)	3,763	3,598	(2,159)	3,257	1,098
Residential mortgage loans	(751)	161	(590)	(3,413)	2,444	(969)
Consumer and other loans	(230)	1,878	1,648	(554)	1,767	1,213
<b>Total interest income</b>	<b>(771)</b>	<b>6,717</b>	<b>5,946</b>	<b>(7,768)</b>	<b>6,034</b>	<b>(1,734)</b>
Interest expense:						
NOW accounts	(285)	94	(191)	79	579	658
Money market accounts	35	57	92	(26)	17	(9)
Savings accounts	(443)	299	(144)	(1,493)	453	(1,040)
Certificate of deposit accounts	(690)	412	(278)	(1,376)	(826)	(2,202)
Overnight & short-term borrowings	31	(14)	17	(124)	(58)	(182)
FHLB and other borrowings	(909)	1,229	320	(1,007)	815	(192)
Capital trust and other subordinated securities	(59)	415	356	(96)	336	240
<b>Total interest expense</b>	<b>(2,320)</b>	<b>2,492</b>	<b>172</b>	<b>(4,043)</b>	<b>1,316</b>	<b>(2,727)</b>
<b>Net interest income</b>	<b>\$ 1,549</b>	<b>\$ 4,225</b>	<b>\$ 5,774</b>	<b>\$ (3,725)</b>	<b>\$ 4,718</b>	<b>\$ 993</b>

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

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

### *Net Interest Income*

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

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**Table of Contents***Interest Income Investments*

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

*Interest Income Loans and Leases*

Interest from loans was \$47.1 million for 2004, and represented a yield on total loans of 5.55%. This compares to \$42.5 million of interest, and a yield of 5.68%, for 2003. Increased interest income resulting from growth in the average balance of loans of \$101.4 million, or 13.6%, was partially offset by a decrease in the yield on loans of 13 basis points. The average balance of the various components of the loan portfolio changed as follows: commercial loans and leases increased \$60.2 million, or 19.5%; consumer and other loans increased \$38.1 million, or 36.9%; and residential mortgage loans increased \$3.1 million, or 0.9%. The yield on the various components of the loan portfolio changed as follows: commercial loans and leases decreased 6 basis points, to 6.25%; consumer and other loans decreased 22 basis points, to 4.90%; and residential mortgage loans decreased 22 basis points, to 5.28%. The decrease in the yield on loans and leases resulted primarily from a drop in market interest rates that occurred towards the end of 2003 and the beginning of 2004. The Company has continued to concentrate its origination efforts on commercial and consumer loan opportunities, but also originates residential mortgage loans for its portfolio on a limited basis. Until such time as the Company can originate sufficient commercial, consumer and residential loans to utilize available cash flow, it intends to continue purchasing residential mortgage loans as opportunities develop.

*Interest Expense Deposits and Borrowings*

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

*Provision for Loan and Lease Losses*

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





**Table of Contents***Noninterest Income*

Total noninterest income decreased \$249,000, or 2.8%, from \$8.8 million for 2003, to \$8.6 million for 2004. Excluding net gains realized, noninterest income increased \$214,000, or 2.8%, as Service charges on deposit accounts (which continues to represent the largest source of noninterest income for the Company) increased \$599,000, or 15.3%, primarily as a result of enhancements to NSF item processing and increased debit card activity. Additionally, Commissions on nondeposit investment products increased \$98,000, or 11.2%, as consumer interest in investment products rebounded, and Other income increased \$257,000, or 26.8%, primarily from commissions generated from sales of tax credits, along with increased credit card and tuition payment activity. Partially offsetting these increases, Commissions on loans originated for others declined \$284,000, or 80.0%, and prepayment penalties on commercial loans declined \$394,000, or 70.2%, from 2003 to 2004. Net Gains on sales of investment securities and MBSs were down \$998,000, or 91.7%, from 2003 to 2004. Also during 2004, the Bank sold its South Broadway, East Providence, office building (leasing back its branch office space). This transaction generated a total gain of \$755,000 of which \$511,000 was recognized and \$244,000 was deferred as a result of the sale-leaseback.

The following table sets forth the components of noninterest income:

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

*Noninterest Expense*

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



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The following table sets forth the components of noninterest expense:

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

*Income Tax Expense*

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

**Comparison of Years Ended December 31, 2003 and December 31, 2002***General*

Net income for 2003 decreased \$448,000, or 5.8%, to \$7.2 million, or \$1.77 per diluted common share, from \$7.7 million, or \$1.92 per diluted common share, for 2002. The Company's performance represented a return on average assets of 0.69% and a return on average equity of 10.45% for 2003, as compared to a return on average assets of 0.81% and a return on average equity of 12.37% for 2002.

Net interest income was \$32.3 million for 2003, compared to \$31.3 million for 2002. The net interest margin for 2003 was 3.28% compared to a net interest margin of 3.48% for 2002. The increase in net interest income of \$993,000, or 3.2%, was primarily attributable to the overall growth of the Company. Average earning assets increased \$87.3 million, or 9.7%, and average interest-bearing liabilities increased \$68.8 million, or 9.0%, over the prior year. The decrease of 20 basis points in the net interest margin was primarily caused by a drop in market interest rates, coupled with higher prepayment activity in residential mortgage loans and MBSs.

*Interest Income Investments*

Total investment income (consisting of interest or dividends on overnight investments, investment securities, mortgage-backed securities, and FHLB stock) was \$9.3 million for 2003, compared to \$12.4 million for 2002. This decrease in total investment income of \$3.1 million, or 24.8%, was attributable to a \$54.2 million, or 30.5%, decrease in the average balance of MBSs and a 59 basis point decrease in the overall yield on investments, from 4.48% in 2002, to 3.89% in 2003. These changes were the result of dramatically lower market interest rates and increased prepayment activity. The majority of the Company's investments at December 31, 2003 were comprised of Agency securities, corporate debt securities and MBSs with either remaining maturities or repricing periods of less than five years. However, in an effort to diversify the portfolio and increase yields, commencing in the fourth quarter of 2002, the Company began investing in corporate debt securities and CMOs. As a result of the low interest rate environment, prepayments on MBSs increased dramatically during the first three quarters of 2003, but appeared to subside in the fourth quarter. Faster prepayment speeds negatively impact the yield of the Company's MBS portfolio, as premiums paid on MBSs must be amortized more quickly and cash flows must be reinvested at lower interest rates.

**Table of Contents***Interest Income Loans and Leases*

Interest from loans and leases was \$42.5 million for 2003, and represented a yield on total loans and leases of 5.68%, as compared to \$41.1 million of interest, and a yield of 6.60%, for 2002. The Company continues to concentrate its origination efforts on commercial and consumer loan opportunities, but also originates residential mortgage loans for its portfolio on a limited basis. In addition, the Company purchases residential mortgage loans as cash flows dictate. Interest from commercial loans increased \$1.1 million, or 6.0%, and consumer and other loan income increased \$1.2 million, or 29.8%, as increased average balances more than offset any decline in average yields. Declining market interest rates, coupled with increased prepayment activity, resulted in residential mortgage loan interest decreasing \$969,000, or 5.2%. In response to declining market interest rates and increased prepayment activity, the yields on the various loan portfolio components changed as follows: commercial loans decreased 78 basis points, to 6.31%; residential mortgage loans decreased 108 basis points, to 5.28%; and consumer and other loans decreased 72 basis points, to 5.12%. In an effort to offset the decrease in yields, the Company attempted to increase the balances in the loan portfolio. The average balance of the various components of the loan portfolio changed as follows: commercial loans increased \$49.4 million, or 19.0%; residential mortgage loans increased \$41.6 million, or 14.2%; and consumer and other loans increased \$33.6 million, or 48.1%. Following a dramatic increase in residential mortgage loan prepayment activity during the second and third quarters of 2003, prepayment speeds returned to lower levels during the fourth quarter.

*Interest Expense Deposits and Borrowings*

Interest paid on deposits and borrowings decreased \$2.7 million, or 12.3%, to \$19.5 million for 2003, compared to \$22.2 million for 2002. The decrease in total interest expense was primarily attributable to the dramatic drop in market interest rates, partially offset by an increase in the average balance of deposits and borrowings. The overall average cost for interest-bearing liabilities decreased 57 basis points from 2.91% for 2002, to 2.34% for 2003. 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. Average costs for the various components of interest-bearing liabilities changed from 2002 as follows: NOW accounts increased 11 basis points, to 1.19%; money market accounts decreased 25 basis points, to 1.04%; savings accounts decreased 51 basis points, to 1.34%; time deposits decreased 63 basis points, to 2.82%; and borrowings decreased 49 basis points, to 4.17%. Partially offsetting the effect of the decline in market interest rates, the average balance of interest-bearing liabilities increased \$68.8 million, from \$761.3 million in 2002, to \$830.2 million in 2003, as NOW and savings account growth, along with additional borrowings, were utilized to fund much of the Company's asset growth. While average certificate of deposit balances decreased by \$25.7 million from 2002 to 2003, the Company began actively advertising for certificates of deposit during the fourth quarter of 2003 and was able to increase their balance by \$11.6 million, or 5.8%, during that quarter.

*Provision for Loan and Lease Losses*

The provision for loan and lease losses was \$1.6 million for 2003, down \$275,000, or 14.7%, from the \$1.9 million for 2002. Management evaluates several factors including new loan originations, delinquency rates, actual and estimated charge-offs, the risk characteristics of the loan and lease portfolio and general economic conditions when determining the provision for each quarter. Also see discussion under *Asset Quality* and *Allowance for Loan and Lease Losses*. Increases to the allowance for loan and lease losses during 2003 were primarily in response to growth in total loans and leases outstanding and continued concern about economic conditions. The allowance, expressed as a percentage of total loans and leases, was 1.36% at December 31, 2003, compared to 1.51% at the prior year-end and stood at 450.0% of nonperforming loans and leases at the end of 2003. 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, which in turn may lead to increases to the provision for loan and lease losses in future periods.

**Table of Contents***Noninterest Income*

Total noninterest income increased \$1.7 million, or 24.7%, from \$7.1 million for 2002, to \$8.8 million for 2003. During 2003, the Company benefited from increased loan prepayment penalties and increased gains from sales of investments. These events generated \$1.3 million, or approximately three-quarters, of the overall increase in noninterest income. The gains from sales of investments resulted from the Company's restructuring of a portion of its investment portfolio and may not be present at these levels in future years. Service charges on deposit accounts, which represent the largest source of noninterest income, rose \$152,000, or 4.0%, from \$3.8 million for 2002, to \$3.9 million for 2003, primarily as a result of growth in checking and savings accounts. Additionally, Income from BOLI increased \$155,000, or 27.3%, as the Company's average balance of BOLI increased from the prior year. Partially offsetting these increases in noninterest income was a decrease in Commissions on nondeposit investment products as funds flowed out of the equity markets during the early part of 2003 and the Company's branch personnel were focused on the core data processing conversion for a portion of the year.

The following table sets forth the components of noninterest income:

	Year ended December 31,	
	2003	2002
	(In thousands)	
Service charges on deposit accounts	\$ 3,915	\$ 3,763
Commissions on nondeposit investment products	875	978
Income from bank-owned life insurance	723	568
Loan related fees	915	688
Commissions on loans originated for others	355	325
Gain on sale of Investments/MBSs	1,088	23
Other income	959	738
<b>Total noninterest income</b>	<b>\$ 8,830</b>	<b>\$ 7,083</b>

*Noninterest Expense*

Noninterest expenses for 2003 increased a total of \$3.8 million, or 15.0%, to \$28.8 million, from \$25.0 million in 2002. This increase occurred primarily as a result of the overall growth of the Company, along with investments in the Bank for a new Operations Center and a new core data processing system, and was centered in the following areas: Salaries and employee benefits (up \$1.3 million, or 9.9%), Occupancy and equipment (up \$880,000, or 29.3%), Data processing (up \$790,000, or 39.8%) and Other expenses (up \$621,000, or 18.9%). Included in the 2003 increases were start-up expenses related to the data processing conversion of approximately \$600,000. In addition, the Bank added 27 full-time equivalent employees ( FTEs ) during 2003 to support its overall growth. It should be noted that by agreement with its executives, the Company did not budget nor pay any bonuses to its executive managers during 2003 as a result of the negative impact that the planned investments in the franchise would have on the Company's earnings.

The following table sets forth the components of noninterest expense:

	Year ended December 31,	
	2003	2002
	(In thousands)	
Salaries and employee benefits	\$ 14,496	\$ 13,185
Occupancy and equipment	3,886	3,006
Data processing	2,777	1,987
Marketing	1,250	1,234
Professional services	1,374	1,380
Loan servicing	1,034	927
Other real estate owned	73	26
Other expenses	3,900	3,279
<b>Total noninterest expense</b>	<b>\$ 28,790</b>	<b>\$ 25,024</b>

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### *Income Tax Expense*

The Company recorded income tax expense of \$3.5 million for 2003, compared to \$3.8 million for 2002. This represented total effective tax rates of 33.0% and 33.4%, respectively. Tax-favored income from BOLI, along with its utilization of a Rhode Island passive investment company, has reduced the Company's effective tax rate from the 40.9% combined statutory federal and state tax rates.

### **Financial Condition**

#### *Loans and Leases Receivable*

Total loans and leases were \$886.3 million, or 71.5% of total assets, at December 31, 2004, compared to \$814.3 million, or 74.4% of total assets, at December 31, 2003, an increase of \$72.0 million, or 8.8%. 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, 2004, are segmented in three broad categories: commercial loans and leases that aggregate \$402.8 million, or 45.4% of the portfolio; residential mortgages that aggregate \$316.1 million, or 35.7% of the portfolio; and consumer and other loans that aggregate \$167.4 million, or 18.9% of the portfolio.

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



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The following is a summary of loans and leases receivable:

	December 31,				
	2004	2003	2002	2001	2000
	(In thousands)				
<b>Commercial loans and leases:</b>					
Commercial real estate nonowner occupied	\$ 90,716	\$ 78,083	\$ 81,242	\$ 73,369	\$ 69,315
Commercial real estate owner occupied	93,027	77,317	59,249	46,698	38,272
Commercial & industrial	78,918	67,925	57,389	53,677	51,470
Small business	37,820	30,429	28,750	24,122	19,170
Multi-family	32,415	28,730	18,952	14,927	15,933
Construction	32,319	30,632	18,101	14,027	7,070
Leases and other	38,116	19,548	17,613	12,715	11,731
<b>Subtotal</b>	<b>403,331</b>	<b>332,664</b>	<b>281,296</b>	<b>239,535</b>	<b>212,961</b>
Discount on leases acquired	(226)				
Net deferred loan origination fees	(335)	(398)	(329)	(171)	(143)
<b>Total commercial loans and leases</b>	<b>402,770</b>	<b>332,266</b>	<b>280,967</b>	<b>239,364</b>	<b>212,818</b>
<b>Residential mortgage loans:</b>					
One- to four-family adjustable rate	199,031	232,543	277,265	285,589	212,197
One- to four-family fixed rate	115,350	131,743	19,310	23,306	34,609
<b>Subtotal</b>	<b>314,381</b>	<b>364,286</b>	<b>296,575</b>	<b>308,895</b>	<b>246,806</b>
Premium on loans acquired	1,826	2,026	1,248	1,381	1,166
Net deferred loan origination fees	(72)	(82)	(60)	(64)	(49)
<b>Total residential mortgage loans</b>	<b>316,135</b>	<b>366,230</b>	<b>297,763</b>	<b>310,212</b>	<b>247,923</b>
<b>Consumer and other loans:</b>					
Home equity term loans	110,542	68,523	47,906	22,930	23,292
Home equity lines of credit	53,551	42,067	37,381	28,460	26,215
Automobile	488	1,455	3,409	6,335	4,643
Installment	491	662	967	1,240	1,348
Savings secured	439	631	602	656	987
Unsecured and other	801	1,787	1,063	1,153	1,044
<b>Subtotal</b>	<b>166,312</b>	<b>115,125</b>	<b>91,328</b>	<b>60,774</b>	<b>57,529</b>
Premium on loans acquired	15	44	103	192	144
Net deferred loan origination costs	1,069	617	497	422	411
<b>Total consumer and other loans</b>	<b>167,396</b>	<b>115,786</b>	<b>91,928</b>	<b>61,388</b>	<b>58,084</b>
<b>Total loans and leases receivable</b>	<b>\$ 886,301</b>	<b>\$ 814,282</b>	<b>\$ 670,658</b>	<b>\$ 610,964</b>	<b>\$ 518,825</b>

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During 2004, the commercial loan and lease portfolio (consisting of commercial real estate, commercial & industrial, leases, multi-family real estate, construction and small business loans) increased \$70.5 million, or 21.2%. The Company believes it is well positioned for continued commercial loan growth. Particular emphasis is placed on generation of small- to medium-sized commercial relationships (those relationships with \$7.0 million or less in total loan commitments). 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. The small business segment of the portfolio increased \$7.4 million, or 24.3%, during 2004. The Bank is a participant in the SBA Preferred Lender Program ( PLP ) in Rhode Island and the 7a Guarantee Loan Program in Massachusetts.

Residential mortgage loans decreased \$50.1 million, or 13.7%, as repayments (\$114.8 million) were greater than the total of purchases (\$55.3 million) and originations (\$9.6 million). Since inception, the Bank has

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concentrated its portfolio lending efforts on commercial and, to a lesser extent, consumer lending opportunities, but originates mortgage loans for its own portfolio, as well as for others, on a limited basis. The Bank does not employ any outside mortgage originators, but from time to time, purchases both fixed and adjustable rate 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.

The consumer loan portfolio is comprised primarily of home equity term loans and home equity lines of credit. During 2004, consumer loan outstandings increased \$51.6 million, or 44.6%, to \$167.4 million at December 31, 2004, from \$115.8 million at December 31, 2003. During 2003 and 2004, in an effort to take advantage of the low interest-rate environment for mortgage refinancings, the Bank promoted its fixed-rate home equity loan product (primarily ten- and fifteen-year maturities), generating \$42.0 million of net loan growth during 2004. The remainder of the growth was in the Bank's home equity line of credit product, which had \$11.5 million of net loan growth during 2004.

The table below shows loan and lease originations, purchases, sales and repayment activities.

	Year ended December 31,				
	2004	2003	2002	2001	2000
	(In thousands)				
Originations and principal additions:					
Loans and leases purchased:					
Commercial loans and leases	\$ 3,257	\$	\$	\$	\$
Residential mortgage loans	55,273	249,656	166,935	186,013	48,491
Consumer and other loans				4,902	4,891
<b>Total loans and leases purchased</b>	<b>58,530</b>	<b>249,656</b>	<b>166,935</b>	<b>190,915</b>	<b>53,382</b>
Loans and leases originated:					
Commercial loans and leases	109,560	106,335	84,132	59,186	65,465
Residential mortgage loans	9,635	28,371	9,345	18,037	9,985
Consumer and other loans	90,655	65,831	51,951	22,332	17,950
<b>Total loans and leases originated</b>	<b>209,850</b>	<b>200,537</b>	<b>145,428</b>	<b>99,555</b>	<b>93,400</b>
Principal reductions:					
Charge-offs/transfers to OREO:					
Commercial loans and leases	(98)	(565)	(400)	(981)	(93)
Residential mortgage loans			(58)	(304)	(148)
Consumer and other loans	(51)	(64)	(93)	(61)	(20)
<b>Total charge-offs/transfers to OREO</b>	<b>(149)</b>	<b>(629)</b>	<b>(551)</b>	<b>(1,346)</b>	<b>(261)</b>
Principal payments:					
Commercial loans and leases	(42,052)	(54,402)	(41,971)	(31,631)	(27,139)
Residential mortgage loans	(114,813)	(210,316)	(188,542)	(141,657)	(47,422)
Consumer and other loans	(39,417)	(41,970)	(21,304)	(23,928)	(12,042)
<b>Total principal payments</b>	<b>(196,282)</b>	<b>(306,688)</b>	<b>(251,817)</b>	<b>(197,216)</b>	<b>(86,603)</b>

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Change in total loans and leases receivable (before net items)	<u>\$ 71,949</u>	<u>\$ 142,876</u>	<u>\$ 59,995</u>	<u>\$ 91,908</u>	<u>\$ 59,918</u>
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The following table sets forth certain information at December 31, 2004, 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.

	<b>Principal repayments contractually due</b>		
	<b>One year or less</b>	<b>After one, but within five years</b>	<b>After five years</b>
	(In thousands)		
Construction/permanent loans	\$ 13,065	\$ 7,662	\$ 11,591
Commercial & industrial loans (including leases)	59,685	46,683	11,024
Small business loans	16,259	15,544	6,017
<b>Total</b>	<b>\$ 89,009</b>	<b>\$ 69,889</b>	<b>\$ 28,632</b>

The following table sets forth as of December 31, 2004, the dollar amount of certain loans due after one year that have fixed interest rates or floating or adjustable interest rates.

	<b>Loans due after one year</b>	
	<b>Fixed rates</b>	<b>Floating or adjustable rates</b>
	(In thousands)	
Construction/permanent loans	\$ 5,489	\$ 13,764
Commercial & industrial loans (including leases)	43,635	14,072
Small business loans	12,015	9,546
<b>Total</b>	<b>\$ 61,139</b>	<b>\$ 37,382</b>

*Asset Quality*

The definition of nonperforming assets includes nonperforming loans and Other real estate owned ( OREO ). OREO consists of real estate acquired through foreclosure proceedings and real estate acquired through acceptance of a deed in lieu of foreclosure. Nonperforming loans are defined as nonaccrual loans, loans past due 90 days or more, but still accruing and impaired loans. Under certain circumstances the Company may restructure the terms of a loan as a concession to a borrower. These restructured loans are considered impaired loans. Included in nonaccrual loans at December 31, 2004, 2003 and 2002, were \$671,000, \$2.1 million and \$224,000 of impaired loans, respectively.

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*Nonperforming Assets.* At December 31, 2004, the Company had nonperforming assets of \$733,000 or 0.06% of total assets. This compares to nonperforming assets of \$2.5 million, or 0.23% of total assets, at December 31, 2003, and nonperforming assets of \$794,000, or 0.08% of total assets, at December 31, 2002. Nonperforming assets at December 31, 2004, consisted of commercial loans aggregating \$709,000 and residential mortgage loans aggregating \$24,000. Nonperforming assets at December 31, 2003 and 2002, were primarily comprised of nonaccrual commercial loans and nonaccrual residential mortgage loans. The Company evaluates the underlying collateral of each nonperforming loan and continues to pursue the collection of interest and principal. Management believes that the December 31, 2004 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.

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The following table sets forth information regarding nonperforming assets.

	December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands)				
Nonaccrual loans	\$ 733	\$ 2,462	\$ 736	\$ 753	\$ 508
Loans past due 90 days or more, but still accruing					
Impaired loans (not included in nonaccrual loans)					
<b>Total nonperforming loans</b>	<b>733</b>	<b>2,462</b>	<b>736</b>	<b>753</b>	<b>508</b>
Other real estate owned			58	264	30
<b>Total nonperforming assets</b>	<b>\$ 733</b>	<b>\$ 2,462</b>	<b>\$ 794</b>	<b>\$ 1,017</b>	<b>\$ 538</b>
Nonperforming loans as a percent of total loans and leases	0.08%	0.30%	0.11%	0.12%	0.10%
Nonperforming assets as a percent of total assets	0.06%	0.23%	0.08%	0.12%	0.07%

*Nonaccrual Loans.* Accrual of interest income on all loans is discontinued when concern exists as to the collectibility of principal or interest, or 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, 2004, nonaccrual loans totaled \$733,000. Interest on nonaccrual loans that would have been recorded as additional income for the year ended December 31, 2004, had the loans been current in accordance with their original terms, totaled \$29,000. This compares with \$298,000 and \$25,000 of foregone interest income on nonaccrual loans for the years ended December 31, 2003 and 2002, respectively.

The following table sets forth certain information regarding nonaccrual loans.

	December 31,					
	2004		2003		2002	
	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans
	(Dollars in thousands)					
Nonaccrual loans:						
Commercial loans and leases	\$ 709	0.08%	\$ 2,256	0.28%	\$ 428	0.07%
Residential mortgage loans	24	0.00%	186	0.02%	291	0.04%
Consumer and other loans		0.00%	20	0.00%	17	0.00%
<b>Total nonaccrual loans</b>	<b>\$ 733</b>	<b>0.08%</b>	<b>\$ 2,462</b>	<b>0.30%</b>	<b>\$ 736</b>	<b>0.11%</b>

*Delinquencies.* At December 31, 2004, \$4.9 million of loans were 30 to 89 days past due. This compares to \$943,000 and \$857,000 of loans 30 to 89 days past due as of December 31, 2003 and 2002, respectively. The majority of these loans at December 31, 2004 and 2002 were commercial loans and at December 31, 2003 were residential mortgage loans.

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



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

	December 31,					
	2004		2003		2002	
	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans	Principal Balance	Percent of Total Loans
(Dollars in thousands)						
<b>Loans delinquent for 30 to 59 days:</b>						
Commercial loans and leases	\$ 3,370	0.38%	\$ 49	0.01%	\$ 563	0.08%
Residential mortgage loans	951	0.11%	250	0.03%	197	0.03%
Consumer and other loans	549	0.06%	47	0.01%	70	0.01%
<b>Total loans delinquent 30 to 59 days</b>	<b>4,870</b>	<b>0.55%</b>	<b>346</b>	<b>0.05%</b>	<b>830</b>	<b>0.12%</b>
<b>Loans delinquent for 60 to 89 days:</b>						
Commercial loans						
Residential mortgage loans			597	0.07%	11	
Consumer and other loans					16	0.01%
<b>Total loans delinquent 60 to 89 days</b>			<b>597</b>	<b>0.07%</b>	<b>27</b>	<b>0.01%</b>
<b>Total loans delinquent 30 to 89 days</b>	<b>\$ 4,870</b>	<b>0.55%</b>	<b>\$ 943</b>	<b>0.12%</b>	<b>\$ 857</b>	<b>0.13%</b>

*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, 2004, the Company had \$5.8 million of assets that were classified as substandard. This compares to \$5.5 million and \$8.4 million of assets that were classified as substandard at December 31, 2003 and 2002, 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, 2004, included in the \$5.8 million of assets that were classified as substandard, were \$5.1 million of performing loans. This compares to \$3.1 million and \$7.6 million of adversely classified performing assets as of December 31, 2003 and 2002, respectively. These amounts constitute assets that, in the opinion of management, could potentially migrate to nonperforming or doubtful status. The decrease in adversely classified assets from 2002 is reflective of successful efforts on the Company's part to resolve substandard credits. Management believes that the December 31, 2004 level of adversely classified assets is low relative to the size and composition of the Company's loan portfolio. As the loan and lease portfolio continues to grow and mature, or if economic conditions worsen, management believes it possible that the level of adversely classified assets will increase. This in turn may necessitate an increase to the provision for loan and lease losses in future periods.

*Allowance for Loan and Lease Losses*

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

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

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

	December 31,									
	2004		2003		2002		2001		2000	
	Amount	Percent of Loans in Each Category to Total	Amount	Percent of Loans in Each Category to Total	Amount	Percent of Loans in Each Category to Total	Amount	Percent of Loans in Each Category to Total	Amount	Percent of Loans in Each Category to Total
(Dollars in thousands)										
Commercial loans and leases	\$ 6,503	45.4%	\$ 4,761	40.8%	\$ 5,250	41.9%	\$ 4,191	39.2%	\$ 3,210	41.0%
Residential mortgage loans	1,644	35.7%	1,922	45.0%	1,757	44.4%	1,835	50.8%	1,460	47.8%
Consumer and other loans	1,745	18.9%	1,248	14.2%	1,027	13.7%	787	10.0%	731	11.2%
Unallocated	2,014	NA	3,147	NA	2,062	NA	1,711	NA	1,893	NA
<b>Total</b>	<b>\$ 11,906</b>	<b>100.0%</b>	<b>\$ 11,078</b>	<b>100.0%</b>	<b>\$ 10,096</b>	<b>100.0%</b>	<b>\$ 8,524</b>	<b>100.0%</b>	<b>\$ 7,294</b>	<b>100.0%</b>

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

A portion of the allowance for loan and lease losses is not allocated to any specific segment of the loan portfolio. This non-specific allowance is maintained for two primary reasons: (i) there exists an inherent subjectivity and imprecision to the analytical processes employed, and (ii) the prevailing business environment, as it is affected by changing economic conditions and various external factors, may impact the portfolio in ways currently unforeseen. Management, therefore, has established and maintains a non-specific allowance for loan losses. The amount of this measurement imprecision allocation was \$2.0 million at December 31, 2004, compared to \$3.1 million at December 31, 2003.

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

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allowance based on their judgments about information available to them at the time of their examination.

During 2004, 2003 and 2002, the Bank made additions to the allowance of \$900,000, \$1.6 million and \$1.9 million and experienced net charge-offs of 72,000, \$618,000 and \$303,000, respectively. At December 31, 2004,

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the allowance for loan and leases losses stood at \$11.9 million and represented 1624.3% of nonperforming loans and 1.34% of total loans outstanding. This compares to an allowance for loan and lease losses of \$11.1 million, representing 450.0% of nonperforming loans and 1.36% of total loans outstanding at December 31, 2003.

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

	Year ended December 31,				
	2004	2003	2002	2001	2000
	(In thousands)				
Balance at beginning of year	\$ 11,078	\$ 10,096	\$ 8,524	\$ 7,294	\$ 5,681
Loans charged-off:					
Commercial loans and leases	(98)	(565)	(400)	(406)	(94)
Residential mortgage loans		(17)			(11)
Consumer and other loans	(52)	(64)	(93)	(61)	(20)
Total loans charged-off	(150)	(646)	(493)	(467)	(125)
Recoveries of loans previously charged-off:					
Commercial loans and leases	70	4	110		191
Residential mortgage loans			40		
Consumer and other loans	8	24	40	28	5
Total recoveries of loans previously charged-off	78	28	190	28	196
Net (charge-offs) recoveries	(72)	(618)	(303)	(439)	71
Provision for loan losses charged against income	900	1,600	1,875	1,669	1,542
Balance at end of year	\$ 11,906	\$ 11,078	\$ 10,096	\$ 8,524	\$ 7,294
Net charge-offs (recoveries) to average loans outstanding	0.01%	0.08%	0.05%	0.08%	(0.01)%

*Investments*

Total investments (consisting of overnight investments, investment securities, MBSs, and FHLB stock) totaled \$291.9 million, or 23.6% of total assets, at December 31, 2004. This compares to total investments of \$215.5 million, or 19.7% of total assets, as of December 31, 2003. The increase of \$76.4 million, or 35.4%, was primarily in overnight investments and MBSs. The cashflows resulting from residential mortgage loan prepayments during the second half of 2004 were utilized to purchase CMOs in an effort to increase the overall yield on the Company's assets.

The investment portfolio provides a source of short-term liquidity and acts as a counterbalance to loan and deposit flows. Investment securities and MBSs are primarily comprised of U.S. Agency securities, but in an effort to diversify the portfolio and increase yields, the Company began investing in corporate debt instruments and CMOs during the fourth quarter of 2002. At December 31, 2004, the Company had a total of \$25.9 million in corporate debt and \$62.0 million in CMOs. This compares with a total of \$36.1 million in corporate debt and \$57.1 million of CMOs at December 31, 2003. All investment securities and MBSs at December 31, 2004 and 2003, were classified as securities available for sale, and

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at December 31, 2004, carried a total of \$1.0 million in net unrealized gains, compared to \$2.4 million in net unrealized gains at December 31, 2003.

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

	Amortized cost	Unrealized		Market value
		Gains	Losses	
(In thousands)				
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
<b>Total</b>	<b>\$ 263,534</b>	<b>\$ 2,182</b>	<b>\$ (1,170)</b>	<b>\$ 264,546</b>
At December 31, 2003:				
U.S. Agency obligations	\$ 57,855	\$ 226	\$ (153)	\$ 57,928
Corporate debt securities	34,704	1,415		36,119
Trust preferred securities	4,269	283	(4)	4,548
U.S. Agency mortgage-backed securities	48,878	629	(26)	49,481
Collateralized mortgage obligations	57,150	254	(267)	57,137
<b>Total</b>	<b>\$ 202,856</b>	<b>\$ 2,807</b>	<b>\$ (450)</b>	<b>\$ 205,213</b>
At December 31, 2002:				
U.S. Agency obligations	\$ 75,137	\$ 1,203	\$ (2)	\$ 76,338
Corporate debt securities	20,367	210		20,577
Trust preferred securities	4,299	184	(69)	4,414
U.S. Agency mortgage-backed securities	150,152	1,856	(61)	151,947
Collateralized mortgage obligations	4,073	94		4,167
<b>Total</b>	<b>\$ 254,028</b>	<b>\$ 3,547</b>	<b>\$ (132)</b>	<b>\$ 257,443</b>

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

	Within one year		After one, but within five years		After five, but within ten years		After ten years	
	Market value	Weighted average yield	Market value	Weighted average yield	Market value	Weighted average yield	Market value	Weighted average yield
(Dollars in thousands)								
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%
<b>Total</b>	<b>\$ 4,073</b>	<b>5.68%</b>	<b>\$ 95,991</b>	<b>3.94%</b>	<b>\$</b>	<b>0.00%</b>	<b>\$ 164,482</b>	<b>4.54%</b>
At December 31, 2003:								
U.S. Agency obligations	\$	0.00%	\$ 48,413	3.73%	\$ 9,515	4.10%	\$	0.00%
Corporate debt securities	4,119	3.87%	32,000	5.14%		0.00%		0.00%
Trust preferred securities		0.00%		0.00%		0.00%	4,548	8.40%
U.S. Agency mortgage-backed securities		0.00%		0.00%		0.00%	49,481	3.67%
Collateralized mortgage obligations		0.00%		0.00%	450	6.50%	56,687	4.45%
<b>Total</b>	<b>\$ 4,119</b>	<b>3.87%</b>	<b>\$ 80,413</b>	<b>4.27%</b>	<b>\$ 9,965</b>	<b>4.21%</b>	<b>\$ 110,716</b>	<b>4.26%</b>
At December 31, 2002:								
U.S. Agency obligations	\$ 2,029	3.26%	\$ 74,309	4.03%	\$	0.00%	\$	0.00%
Corporate debt securities		0.00%	20,577	5.92%		0.00%		0.00%
Trust preferred securities		0.00%		0.00%		0.00%	4,414	8.40%
U.S. Agency mortgage-backed securities		0.00%		0.00%	1,534	2.24%	150,413	4.25%
Collateralized mortgage obligations		0.00%		0.00%		0.00%	4,167	6.35%
<b>Total</b>	<b>\$ 2,029</b>	<b>3.26%</b>	<b>\$ 94,886</b>	<b>4.44%</b>	<b>\$ 1,534</b>	<b>2.24%</b>	<b>\$ 158,994</b>	<b>4.42%</b>

*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 2004, 2003 and 2002, the Bank purchased \$2.0 million, \$0 and \$14.2 million of BOLI, respectively. The cash surrender value of





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these life insurance policies was \$18.1 million and \$15.5 million at December 31, 2004 and 2003, respectively. The Bank recorded income from the BOLI policies of \$641,000 in 2004, \$723,000 in 2003 and \$568,000 in 2002.

*Deposits and Borrowings*

The Company has devoted considerable time and resources to its deposit gathering network. The Company experienced a net increase of \$69.4 million, or 8.6%, in total deposits during 2004, to \$880.7 million at December 31, 2004, from \$811.3 million at December 31, 2003. This increase in total deposits can be broken down as follows: demand deposit accounts were up \$7.8 million, or 4.9%, savings accounts were up \$47.6 million, or 16.3%, and CDs were up \$35.8 million, or 16.8%. Meanwhile, NOW and money market accounts were down \$21.7 million, or 14.8%, for the year. The growth in checking and savings accounts occurred during the first half of 2004. During the latter half of 2004, checking balances decreased, reflecting increased volatility. In addition, as short-term interest rates rose, interest-bearing core deposits began to shift into CDs as consumers sought higher yields on their short-term savings. By comparison, total deposits increased \$49.4 million, or 6.5%, during 2003 and can be summarized as follows: demand deposit accounts increased \$22.0 million, or 15.9%, NOW accounts increased \$28.9 million, or 28.8%, and CDs decreased \$9.1 million, or 4.1%, during 2003.

The following table sets forth certain information regarding deposits:

	December 31,								
	2004			2003			2002		
	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	\$ 108,159	12.3%	0.76%	\$ 129,398	16.0%	1.13%	\$ 100,476	13.2%	1.37%
Money market accounts	16,489	1.9%	1.22%	16,937	2.1%	1.29%	10,660	1.4%	1.00%
Savings accounts	339,836	38.6%	1.25%	292,277	36.0%	1.18%	290,981	38.2%	1.70%
Certificate of deposit accounts	248,508	28.2%	2.55%	212,755	26.2%	2.55%	221,874	29.1%	3.07%
Total interest bearing deposits	712,992	81.0%	1.63%	651,367	80.3%	1.62%	623,991	81.9%	2.12%
Noninterest bearing accounts	167,682	19.0%	0.00%	159,916	19.7%	0.00%	137,920	18.1%	0.00%
Total deposits	\$ 880,674	100.0%	1.32%	\$ 811,283	100.0%	1.30%	\$ 761,911	100.0%	1.74%

At December 31, 2004, CDs with balances greater than \$100,000 aggregated \$52.4 million, compared to \$31.0 million and \$30.5 million at December 31, 2003 and 2002, respectively.

Overnight and short-term borrowings, along with FHLB borrowings, increased \$62.6 million, or 32.9%, during 2004, to \$252.8 million, from \$190.2 million at December 31, 2003. The Company had \$171.3 million of borrowings outstanding at the end of 2002. The increase during 2004 was the result of the Company utilizing FHLB borrowings to take advantage of long-term borrowing rates to partially fund its asset growth and

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partially to offset some deposit softness that occurred during the second half of 2004. The Bank, through its membership in the FHLB, has access to a variety of borrowing alternatives, and management will from time to time take advantage of these opportunities to fund asset growth. However, on a long-term basis, the Bank intends to concentrate on increasing its core deposits.

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**Subordinated Deferrable Interest Debentures**

On both March 17, 2004, and June 26, 2003, the Company issued \$5.2 million of subordinated deferrable interest debentures to one of its statutory trust subsidiaries bringing its total outstanding of subordinated deferrable interest debentures to \$18.6 million. The securities issued in March 2004 have a floating interest rate equal to 3 month LIBOR plus 2.79% and mature in 30 years. The securities issued in June 2003 have a 5.55% coupon, fixed for the first five years, then converting to a floating interest rate equal to 3 month LIBOR plus 3.10% and mature in 30 years. The statutory trust subsidiary then participated in the issuance of pooled trust preferred securities of similar terms and maturity. The regulatory capital generated from issuing the trust preferred securities helped support the Company's continued asset growth. In accordance with Financial Accounting Standards Board ( FASB ) Interpretation 46-R *Consolidation of Variable Interest Entities Revised* , the statutory trust subsidiaries utilized in the issuance of trust preferred securities were deconsolidated from the Company's financial statements, effective December 31, 2003.

**Liquidity and Capital Resources**

*Liquidity*