BANCORP RHODE ISLAND INC
Form 10-K
March 16, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.
FORM 10-K
(Annual Report Under Section 13 of the Securities Exchange Act of 1934)
For the fiscal year ended December 31, 2009
Commission File No. 001-16101
BANCORP RHODE ISLAND, INC.
(Exact Name of Registrant as Specified in Its Charter)

Rhode Island	05-0509802
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

ONE TURKS HEAD PLACE, PROVIDENCE, RI 02903
(Address of Principal Executive Offices)
(401) 456-5000
(Issuer s Telephone Number, Including Area Code)
Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.01 per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ
Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) 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 þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o
Indicate by check mark 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. þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
As of June 30, 2009, the aggregate market value of the voting common equity of the Registrant held by non-affiliates of the Registrant, based on the closing price on the Nasdaq Global Select Market SM was $72,380,323.

As of February 28, 2010, there were 4,617,594 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 2010 Annual Meeting of Shareholders are incorporated by reference into Parts II and III of this Form 10-K.

See pages 57 to 59 for the exhibit index.

Bancorp Rhode Island, Inc.
Annual Report on Form 10-K
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PART I

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

We make certain forward looking statements in this Annual Report on Form 10-K and in other documents that we incorporate by reference into this report that are based upon our current expectations and projections about future 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 variatio

These forward looking statements include:

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

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

ITEM 1. BUSINESS

Introduction

Bancorp Rhode Island, Inc. (we or the Company), a Rhode Island corporation, is the holding company for Bank Rhode Island (the Bank). The Company has no significant assets other than the common stock of the Bank. For this reason, substantially all of the discussion in this document relates to the operations of the Bank and its wholly-owned subsidiaries, which include BRI Investment Corp. (a Rhode Island passive investment company), Macrolease Corporation (an equipment financing company), Acorn Insurance Agency, Inc. (a licensed insurance agency) and BRI Realty Corp. (a real estate holding company).

The Bank is a commercial bank chartered as a financial institution in the State of Rhode Island and was formed in 1996 as a result of the acquisition of certain assets and liabilities divested in connection with the merger of Fleet Financial Group, Inc. and Shawmut National Corporation. Headquartered in Providence, Rhode Island, the Bank conducts business through 16 full-service branches, with 12 located in Providence County, 3 located in Kent County and 1 located in Washington County. The Bank augments its branch network through online banking services and automatic teller machines (ATMs), both owned and leased, located throughout Rhode Island.

The Bank provides a community banking alternative in the greater Providence market which is dominated by three large banking institutions, two national and one regional. Based on total deposits as of June 30, 2009 (excluding one bank that draws its deposits primarily from the internet), the Bank is the fifth largest bank in Rhode Island and the only mid-sized commercially focused bank headquartered in Providence, the State s capital. The Bank offers its customers a wide range of business, commercial real estate, consumer and residential loans, commercial leases, deposit products, nondeposit investment products, cash management and online banking services, private banking and other banking products and services designed to meet the financial needs of individuals and small- to mid-sized businesses. As a full-service community bank, the Bank seeks to differentiate itself from its large bank competitors through superior personal service, responsiveness and local decision-making. The Bank s deposits are insured by the FDIC, subject to regulatory limits.

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

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

Overview

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

In March 2009, the Bank marked its thirteenth year in business. During the past thirteen years, the Company has grown its assets, deposits and customer base significantly and has expanded the depth and breadth of its management team and staff. Also, the Bank has substantially enlarged and improved its branch network and enhanced its operating systems and infrastructure. The Bank was named the U.S. Small Business Administration s (SBA) No. 1 lender in Rhode Island as of the SBA s September 30, 2009 fiscal year end.

The Company continues to transition from a young, high growth *de novo* bank into a more mature institution, which seeks to better leverage the footprint it has built and investments it has made. The Company continued to achieve double-digit commercial loan and lease growth in 2009, with commercial outstandings increasing 11.2% from $658.4 million at the prior year-end to $732.4 million at December 31, 2009. Residential mortgages and consumer loans declined compared to 2008 as the Company continued its strategic conversion to a more commercially-oriented balance sheet.

During the year, the Company added $9.9 million to its allowance for loan and lease losses. The provision exceeded net charge-offs by $1.9 million. The increased provision served to strengthen the ratio of the allowance to loans and leases to 1.49 percent at December 31, 2009, up from 1.36 percent at December 31, 2008. Nonperforming loans and leases at December 31, 2009 totaled $18.3 million, up from $14.4 million a year ago. As a percentage of total loans and leases, nonperforming loans and leases ended 2009 at 1.65 percent, compared to 1.33 percent at the end of the year in 2008. The Company believes its net charge-offs and nonperforming loan and lease ratio continue to compare favorably to its peer group, reflecting a culture of prudence and diligence in its risk management practices and business approach.

Competition for deposits remained strong in the Bank s primary market area. In 2009, the Bank s core deposits increased by $92.4 million, or 14.9%, which was offset by a decrease in certificate of deposit accounts of $36.3 million, or 8.6%. Overall, the Bank increased its total deposits by $56.1 million, or 5.4%, year-over-year. The increase in total deposits reflects the Bank s strategic efforts to expand its commercial deposit relationships with existing and new customers and sales of retail deposit products through its branch network and in conjunction with consumer lending programs.

The Bank s North Kingstown, East Greenwich, Lincoln and Pawtucket branches all continue to make progress. Each of the branches, opened from 2004 to 2007, realized deposit growth in 2009. In the aggregate, the new branches increased their deposits by $15.8 million, or 14.3%, to $110.3 million during 2009. The Lincoln branch experienced the largest increase in deposit balances ($6.2 million, or 20.9%, year over year) while the North Kingston branch, whose deposits aggregated $48.9 million, had the least deposit growth of the new branches ($2.8 million, or 6.0%, compared to December 31, 2008).

The Company continued to proactively manage its balance sheet, resulting in a 4 basis point increase year over year despite declining rates of interest-earning assets. During 2009, the Company realized $61,000 in gains on sales of mortgage-backed securities. Additionally, the Company maintained its quarterly dividend of $0.17 per share throughout 2009.

Noninterest income declined $1.4 million, or 13.6%, to $9.2 million in 2009 as compared to 2008. Deposit service charges continue to account for over half of the Company s noninterest income, slightly increasing to 58.7% in 2009 from 53.8% in 2008.

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While the Company s efficiency ratio increased from 67.68% in 2008 to 68.76% in 2009, management s focus on expense control limited the noninterest expense increase to only $1.6 million, or 4.3%, despite increases in FDIC insurance costs of $1.8 million.

During 2009, the Company continued to add breadth and depth to its senior management team with the addition of in-house counsel and senior vice presidents responsible for loan origination and retail banking. The Company also expanded its business development team after successfully adding a position in 2008. The Company believes that these management changes will improve its overall administration as well as promote business development.

Capital Strength and Exit from the U.S. Treasury s Capital Purchase Program

In December 2008, the Company became a participant in the U.S. Treasury Department s Capital Purchase Program (CPP) and issued the U.S. Treasury 30,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a liquidation value of $1,000 per share and a warrant to purchase 192,967 shares of common stock at an exercise price of $23.32 per share.

On August 5, 2009, the Company repurchased the preferred stock issued to the U.S. Treasury for $30.0 million plus accrued dividends through the date of repurchase of $333,000 and exited the CPP. The repurchase of the preferred stock resulted in the recognition of $1.3 million in prepayment charges on the discount associated with its issuance. On September 30, 2009, the Company repurchased the warrant for $1.4 million.

While the Company was not required to raise additional capital in order to repay the CPP funds, the Company s Board of Directors (the Board) believed it was prudent to assure access to capital on reasonable terms should economic conditions continue or worsen. Also, a commitment for additional capital would provide the Company with increased flexibility in responding to market developments. For these reasons, the Company entered into a Standby Commitment Letter Agreement on August 5, 2009 with a trust of which Malcolm G. Chace, the Company s Chairman of the Board and owner of more than 10% of the Company s outstanding common stock, is a trustee and beneficiary. Pursuant to this commitment, the Company will have the right, exercisable at any time through February 5, 2011, to require the Chace Trust to purchase up to $8.0 million of trust preferred securities to be issued by a trust subsidiary of the Company. The terms of the commitment and trust preferred securities are more fully described under Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Capital Resources. As consideration for the commitment, the Company paid a $320,000 commitment fee, representing 4% of the maximum commitment.

As of December 31, 2009, the Company and the Bank remained well-capitalized by the standards established by the Board of Governors of the Federal Reserve System (FRB) and FDIC. The Company s Tier 1 Capital Ratio, Tier 1 Risk-Based Capital Ratio and Total Risk-Based Capital Ratio were 7.65%, 10.71% and 11.97%, respectively, as of December 31, 2009. The Bank s Tier 1 Capital Ratio, Tier 1 Risk-Based Capital Ratio and Total Risk-Based Capital Ratio were 7.54%, 10.55% and 11.81%, respectively, as of December 31, 2009. These capital ratios and requirements are further discussed at *Regulatory Capital Requirements* on pages 11 and 12. The Company s tangible common equity ratios of 6.87% and 7.15% at December 31, 2009 and 2008, respectively, also demonstrate the Company s capital strength.

Lending Activities

The Bank s business strategy has been to grow its commercial and consumer loan and lease portfolios while allowing its residential mortgage loan portfolio to decline gradually as a percent of total loans and leases. The Bank has allocated substantial resources to its commercial and consumer lending functions to facilitate and promote such growth. From December 31, 2004 through December 31, 2009, commercial loan and lease outstandings have increased $329.6 million, or 81.8%, and represent 65.9% of total loans and leases at December 31, 2009 compared to 45.4% at December 31, 2004. Consumer loan outstandings have increased $38.8 million, or 23.2%, from December 31, 2004 through December 31, 2009, but have remained fairly consistent as a percentage of total loans and leases. Consumer loans decreased slightly from 18.9% of total loans and leases at December 31, 2004 to 18.5% of total loans and leases at December 31, 2009. Meanwhile, residential mortgage loans decreased from 35.7% of total loans and leases at December 31, 2004 to 15.6% of total loans and leases at December 31, 2009.

The Bank offers a variety of loan facilities to serve both commercial and consumer borrowers primarily within the State of Rhode Island and nearby areas of Massachusetts. Approximately 66% of Rhode Island businesses, 76% of

Rhode Island jobs and 76% of the Rhode Island population are located in Providence and Kent Counties. More than 98% of Rhode Island businesses have fewer than 100 employees. The Bank believes the financing needs of these businesses generally match the Bank s lending profile and that the Bank s branches are well positioned to facilitate the generation of loans from this customer base.

The Bank s commercial lending function is organized into two groups. The business lending group originates business loans and leases, often referred to as commercial and industrial loans and leases, including owner-occupied commercial real estate loans, term loans, revolving lines of credit and equipment leases (through the Bank s subsidiary, Macrolease). The commercial real estate group originates nonowner-occupied commercial real estate, multi-family residential real estate and construction loans.

The Bank s branch network and business development team also play a role in business lending relationships under $1.0 million. Underwriting, processing and monitoring the bulk of business credit relationships under $1.0 million are supported by the Bank s lending services group. The lending services group also processes and monitors consumer loans. The creation of the lending services group has enhanced the Bank s ability to reach more borrowers with the same number of personnel as well as achieve more efficient processing and monitoring of these credits.

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

The Bank has tiered lending authorities. Certain senior executives have lending approval authority up to $3.0 million. Extensions of credit to a customer relationship greater than established authority levels (up to the Bank s house lending limit of $10.0 million) require the approval of the Credit Committee, which consists of members of the Bank s senior management and one outside director. Exceptions to the Bank s house lending limit require the approval of a committee of the Board of Directors. Other officers have limited lending authorities that can be exercised subject to lending policy guidelines to facilitate production volume 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, 2009, the Bank had $219.7 million of aggregate commitments outstanding to fund loans and leases.

Overall, loans and leases produced total interest income of $59.8 million, or 79.4% of total interest and dividend income, in 2009 and $63.0 million, or 78.5% of total interest and dividend income, during 2008.

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, 2009, owner-occupied commercial real estate loans totaled $167.9 million, or 15.1% of the total loan and lease portfolio. Many of these customers have other commercial borrowing relationships with the Bank, as the Bank finances their other business needs. Generally these customer relationships are handled in the Bank s business lending group. Nonowner-occupied commercial real estate loans totaled $170.1 million, or 15.3% of the total loan and lease portfolio, and multi-family residential loans totaled $66.4 million, or 6.0% of the total loan and lease portfolio, and are generally handled in the Bank s commercial real estate group. These real estate secured commercial loans are offered as both fixed and adjustable rate products. The Bank typically charges higher interest rates on these loans than those charged on adjustable rate loans secured by one- to four-family residential units. Additionally, the Bank may charge origination fees on these loans.

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

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

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. The Bank utilizes credit scoring in evaluating business loans of up to $750,000. Commercial lending activities are supported by noncredit products and services, such as letters of credit and cash management services, which are responsive to the needs of the Bank s commercial customers.

At December 31, 2009, commercial and industrial loans totaled $178.8 million, or 16.1% of the total loan and lease portfolio. Macrolease-generated equipment loans accounted for $43.1 million of the commercial and industrial portfolio. Generally, commercial and industrial loans have relatively shorter maturities than residential and commercial real estate loans, or are at adjustable rates without interest rate caps. Unlike residential and commercial real estate loans, which generally are based on the borrower s ability to make repayment from employment and rental income and which are secured by real property whose value tends to be relatively easily ascertainable, commercial and industrial loans are typically made on the basis of the borrower s ability to make repayment from the cash flow of the business and are generally secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial and industrial loans may be significantly dependent on the success of the business itself. Further, the collateral securing the loans may be difficult to value, may fluctuate in value based on the success of the business and may deteriorate over time.

Leases At December 31, 2009, leases comprised 6.1% of the total loan and lease portfolio. In May 2005, the Bank, through its Macrolease subsidiary, purchased substantially all of the operating assets of Macrolease International Corporation, a privately held national equipment financing company based on Long Island in Plainview, New York. With the Macrolease platform, the Bank originates equipment leases for its own portfolio, as well as originating leases for third parties as a source of noninterest income. From time to time, Macrolease purchases leases from third parties. Macrolease-generated leases were $54.5 million at December 31, 2009. Leases sold during 2009 totaled $11.1 million, which generated $326,000 of noninterest income.

In addition to the Macrolease platform, the Bank purchases equipment leases from originators outside of the Bank. The U.S. Government and its agencies are the principal lessees on the purchased leases. These government leases generally have maturities of five years or less and are not made dependent on residual collateral values. At December 31, 2009, the commercial loan and lease portfolio included $12.9 million of purchased government leases.

Small Business Loans The Bank utilizes the term small business loans to describe business lending relationships of approximately $500,000 or less which it originates through business development officers and its branch network. These loans are generally secured by the assets of the business, as well as the personal guarantees of the business principal owners. A number of these loans are granted in conjunction with the SBA s Low-Doc and Express programs and include some form of SBA credit enhancement. At December 31, 2009, small business loans totaled $56.1 million, or 5.1% of the total loan and lease portfolio. Generally, small business loans are granted at higher rates than commercial and industrial loans. These loans have relatively short-term maturities or are at adjustable rates without interest rate caps.

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

Construction Loans The Bank originates residential construction loans to builders to construct one- to four-family residential units for resale. The Bank also makes construction loans for the purpose of constructing multi-family or commercial properties. At December 31, 2009, outstanding construction loans totaled $23.4 million, or 2.1% of the total loan and lease portfolio. During the construction period, these loans are generally on an interest-only basis.

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

The risks associated with construction lending are greater than those with commercial real estate lending and multi-family lending on existing properties for a variety of reasons. The Bank seeks to minimize these risks by, among other things, often using the inspection services of a consulting engineer for commercial construction loans, advancing money during stages of completion and generally lending for construction of properties within its market area to borrowers who are experienced in the type of construction for which the loan is made, as well as by adhering to the lending standards described above. The Bank generally requires from the borrower evidence of either pre-sale or pre-lease commitments on certain percentages of the construction project for which the loan is made.

Residential Mortgage Loans The Bank s one- to four-family residential mortgage loan portfolio consists primarily of whole loans purchased from other financial institutions. In past years, the Bank purchased fixed- and adjustable-rate (ARM) mortgage whole loans from other financial institutions both in New England and elsewhere in the country. The Bank performed due diligence procedures when purchasing these mortgages considering the loan characteristics such as debt to income ratio, loan to value ratio, credit score, property type and the level of credit enhancement. Although the Bank has not purchased any mortgages since 2007, the Bank anticipates continuing to purchase residential mortgage loans to the extent its commercial and consumer loan originations are not sufficient to fully utilize available cash flows. With the exception of approximately $29.0 million of purchased mortgages, 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, 2009, approximately 34% of the residential mortgage loan portfolio consisted of loans secured by real estate outside of New England.

Additionally, largely as an accommodation to the Bank s customers, fixed- and variable-rate mortgages are offered throughout the Bank s branch network. The majority of these mortgages are transferred to the Bank s correspondent third parties under precommitments to fund these transactions. However, the Bank does retain a portion of these residential mortgages for its own portfolio. In 2009, fees from these loans originated for third parties decreased to $83,000 from $100,000 in the prior year. Overall, the Bank anticipates that its residential mortgage loan portfolio will decline long-term as it continues to focus its resources on commercial and consumer lending.

At December 31, 2009, one- to four-family residential mortgage loans totaled $173.3 million, or 15.6% of the total loan and lease portfolio. The fixed rate portion of this portfolio totaled $56.7 million and had original maturities of 15 to 30 years. The adjustable rate portion of this portfolio totaled $115.9 and generally had original maturities of 30 years. Interest rates on adjustable rate loans are set for an initial period of one, three, five, seven or ten years with annual adjustments for the remainder of the loan. These loans have periodic rate adjustment caps of primarily 2% and lifetime rate adjustment caps of either 5% or 6%. There are no prepayment penalties for the one- to four-family residential mortgage loans.

Although adjustable rate mortgage loans allow the Bank to increase the sensitivity of its assets to changes in market interest rates, the terms of such loans include limitations on upward and downward rate adjustments. These limitations increase the likelihood of prepayments due to refinancings during periods of falling interest rates, particularly if rate adjustment caps keep the loan rate above market rates. Additionally, these limitations could keep the market value of the portfolio below market during periods of rising interest rates, particularly if rate adjustment caps keep the loan rate below market rates.

Consumer and Other Loans The Bank originates a variety of term loans and lines of credit for consumers. At December 31, 2009, the consumer loan portfolio totaled $206.2 million, or 18.5% of the total loan and lease portfolio. Over the past 5 years, consumer loans have increased by $38.8 million, or 23.2%. Compared to the prior year-end, consumer loans have decreased by $499,000, or 0.2%. The slight decrease in consumer and other loans from 2008 to 2009 reflects the runoff of existing consumer loans exceeding new originations.

Home equity term loans and home equity lines of credit comprised 98.8% of the consumer loan portfolio at December 31, 2009. 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.

Asset Quality

The continued weak economy resulted in increased nonperforming assets and net charge-offs in 2009. At December 31, 2009, the Company had nonperforming assets of $20.0 million, or 1.26% of total assets, compared to $15.2 million, or 1.00% of total assets, at December 31, 2008. The Bank made additions to the allowance for loan and lease losses of $9.9 million and $4.5 million during 2009 and 2008 and experienced net charge-offs of $8.0 million and $2.5 million, respectively. At December 31, 2009, the allowance for loan and leases losses was $16.5 million and represented 1.49% of total loans and leases outstanding. This compares to an allowance for loan and lease losses of $14.7 million, representing 1.36% of total loans and leases outstanding at December 31, 2008. If current economic conditions continue or worsen, management believes that the level of nonperforming assets will increase, as will its level of charged-off loans and leases.

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Investment Activities

Investments, an important component of the Company s diversified asset structure, are a source of earnings in the form of interest and dividends, and provide a source of liquidity to meet lending demands and fluctuations in deposit flows. Overall, the portfolio, comprised primarily of overnight investments, government sponsored enterprise (GSE) obligations, U.S Treasury obligations, mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs) and Federal Home Loan Bank of Boston (FHLB) stock, represents $400.1 million, or 25.2% of total assets, as of December 31, 2009. The majority of these securities are rated investment grade by at least one major rating agency. Loans and leases generally provide a better return than investments, and accordingly, the Company seeks to emphasize their generation rather than increasing its investment portfolio. The investments are managed by the Bank s Chief Financial Officer and Treasurer, subject to the supervision and review of the Asset/Liability Committee and are made in compliance with the Investment Policy approved by the Bank s Board of Directors.

Overall, in 2009, investments produced total interest and dividend income of $15.5 million, or 20.6%, of total interest and dividend income compared to $17.3 million, or 21.5% of total interest and dividend income, during 2008.

Deposits and Service Charges on Deposit Accounts

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

The Bank seeks to develop relationships with its customers in order to become their primary bank. In order to achieve this, the Bank has stressed growing its core deposit account base. Core deposits increased $92.4 million, or 14.9%, compared to the prior year. Within core deposits, demand deposit accounts increased to $204.3 million at December 31, 2009 from $176.5 million at December 31, 2008. Within total deposit growth, the balance sheet mix shifted from certificate of deposits to core deposit accounts. Savings balances declined to $367.2 million at December 31, 2009, a decrease of $13.9 million, or 3.6%, while certificate of deposit accounts decreased $36.3 million, or 8.6%, to $387.1 million at December 31, 2009. Core deposits as a percentage of total deposits increased to 64.8% at December 31, 2009 from 59.4% at December 31, 2008. Overall, total deposits increased $56.1 million, or 5.4%, at December 31, 2009 as compared to the prior year.

As a by-product of the Bank s emphasis on checking account growth, as well as deposit fee enhancement programs, service charges on deposit accounts, which include nonsufficient funds (NSF) fees, have grown over the years and represent the largest source of noninterest income for the Company. Service charges on deposit accounts decreased by $334,000, or 5.8%, from $5.7 million for 2008, to $5.4 million for 2009. Management believes the decline reflects a national trend driven by consumers aversion to unnecessary spending. If this trend continues or worsens, noninterest income may remain at or further decline from levels previously experienced. Additionally, in 2009, the FRB finalized changes to its consumer electronic funds transfer regulation (Regulation E). The changes limit the ability of financial institutions to charge NSF fees in certain circumstances. These changes to Regulation E will be effective July 1, 2010 and will require financial institutions to obtain consumer consent, or opt-in , before charging a consumer for paying overdrafts on automated teller machine and one-time debit card transactions. Management believes these changes will have a negative impact on noninterest income. There is also legislation pending in the U.S. Senate to further restrict NSF fees by limiting the number of overdrafts for which a financial institution may charge a consumer to one per month with an annual limit of six overdraft fees. If enacted, these proposed changes are likely to have a negative effect on the Bank s noninterest income.

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

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Borrowings and Liquidity

The Bank derives cash flows from several sources, including loan and lease repayments, deposit inflows and outflows, sales of available for sale securities and FHLB and other borrowings. Loan and lease repayments and deposit inflows and outflows are significantly influenced by prevailing interest rates, competition and general economic conditions. To broaden its liquidity sources, the Bank uses such resources as brokered deposits, repurchase agreements and lines at the FRB.

The Bank utilizes borrowings on both a short- and long-term basis to compensate for reductions in normal sources of funds on a daily basis and as opportunities present themselves. The Bank will utilize borrowings and invest excess cash as part of its overall strategy to manage interest rate risk. At December 31, 2009, total borrowings were $350.8 million compared to $320.0 million at December 31, 2008.

The Bank has taken notice of the concerns that have been expressed about the FHLB and its ability to continue to repurchase member stock and discontinued dividends on its stock. As a member of the FHLB, the Bank is required to purchase FHLB stock in association with the Bank s outstanding advances. This stock is classified as a restricted investment and carried at cost. The FHLB is currently operating with retained earnings below its targeted level and has suspended its quarterly dividend and excess stock repurchases. The Bank will continue to monitor the credit quality of its funding sources, including the FHLB, and the related impact on its FHLB stock.

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 primarily offered through an arrangement with Commonwealth Equity Services, Inc., of Waltham, Massachusetts (Commonwealth). Commissions on nondeposit investment products for the years ending December 31, 2009 and 2008 were $776,000 and $745,000, respectively.

Employees

At December 31, 2009, the Company had 240 full-time and 26 part-time employees. The Company s employees are not represented by any collective bargaining unit, and the Company believes its employee relations are good. The Company maintains a benefit program that includes health and dental insurance, life and long-term disability insurance and a 401(k) plan.

Supervision and Regulation

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

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

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (BHC Act). As a bank holding company, the Company is regulated by 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 Deposit Insurance Fund (DIF) of the FDIC. Accordingly, the Bank is subject to the supervision and regulation of the FDIC and the Rhode Island Department of Business Regulation (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 (Director) may, under certain circumstances, restrict the withdrawal of deposits, order any person to cease violating any Rhode Island statutes or rules and regulations or cease engaging in any unsafe, unsound or deceptive banking practice, order that capital be restored, or suspend or remove directors, committee members, officers or employees who have violated the Rhode Island banking statutes, or a rule or regulation or order thereunder, or who are reckless or incompetent in the conduct of the bank s business.

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

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

Federal Supervision: FDIC

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

The Bank is subject to the FDIC regulatory capital requirements described below under 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 DIF of the FDIC to the legal maximum for each separately insured depositor. The Federal Deposit Insurance Act, as amended (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 DIF reserves to insured deposits in the DIF 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. Under the Federal Deposit Insurance Reform Act of 2005, which became law in 2006, the Bank received a one-time assessment credit of $585,000 that could be applied against premiums, subject to certain limitations. The Bank paid a minimum assessment of $2,000 in 2007, largely through the utilization of this one-time credit. In 2008, the Bank fully utilized the remainder of this credit. On May 22, 2009, the FDIC imposed a 5 basis point special assessment on the assets less Tier 1 Capital as of June 30, 2009 of all FDIC-insured institutions. The FDIC is authorized to levy an additional 5 basis points in special assessments. In addition to the special assessment, FDIC regular assessments increased for 2009. During 2008, financial institutions were assessed rates ranging from 5 basis points per $100 of deposits for institutions in Risk Category I to 43 basis points for institutions assigned to Risk Category IV. In 2009, rates ranged from 12 to 50 basis points per $100 of deposits.

In the fourth quarter of 2009, the FDIC voted to require insured institutions to prepay thirteen quarters of estimated insurance assessments. The estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012 were paid on December 30, 2009. Unlike the special assessment, the pre-payment allows the FDIC to strengthen the cash position of the DIF immediately without immediately impacting bank earnings.

The Emergency Economic Stabilization Act became law on October 3, 2008 and provides for a temporary increase in the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The basic deposit insurance limit will return to $100,000 on December 31, 2013. In addition, on October 14, 2008, the FDIC instituted a Temporary Liquidity Guarantee Program that provided for temporary unlimited FDIC coverage of non-interest-bearing deposit transaction accounts, low interest NOW accounts (NOW accounts that cannot earn more than 0.50% interest) and IOLTA accounts (transaction accounts). Institutions were automatically covered, without cost, under these programs for 30 days (later extended until December 5, 2008); however, after the specified deadline (December 5, 2008), institutions were required to opt-out of these programs if they did not wish to participate and incur fees thereunder. The Company elected to participate in the Transaction Account Guarantee Program (TAG program), which was extended to June 30, 2010. The initial TAG program expired on December 31, 2009 unless the institution elected to opt out of the extended TAG program. Under the TAG program in effect through December 31, 2009, an institution could provide full coverage on transaction accounts for an annual assessment of 10 basis points of any deposit amounts exceeding the $250,000 deposit insurance limit, in addition to the normal risk-based assessment. An institution that did not elect to opt out of the extended TAG program can provide full coverage on transaction accounts through June 30, 2010 for the annual assessment ranging from 15 basis points to 25 basis points, depending on the institution s Risk Category. The Company elected to participate in the extended TAG program. The expiration of the TAG program on June 30, 2010 could have an adverse impact on the deposit levels of customers that are sensitive to full FDIC insurance coverage.

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.

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

Federal Supervision: FRB

The BHC Act mandates that the prior approval of the FRB must be obtained in order for the Company to engage in certain activities such as acquiring or establishing additional banks or non-banking subsidiaries or merging with other institutions and imposes capital adequacy requirements as described below under Regulatory Capital Requirements.

Regulatory Capital Requirements

FDIC Requirements 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 capital ratio calculated using Tier 1 capital (as defined below) to total assets (Tier 1 Leverage Ratio) 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 capital-to-risk weighted asset ratios based on Tier 1 capital (Tier 1 Risk-Based Capital Ratio) of at least 4.0% and on total capital (Total Risk-Based Capital Ratio) of at least 8.0%. The guidelines provide a general framework for assigning assets and off-balance sheet items (such as standby letters of credit) to broad risk categories and provide procedures for the calculation of the Risk-Based Capital Ratio. Tier 1 (sometimes referred to as core) capital consists of common shareholders equity, qualifying, non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. Supplementary or Tier 2 capital includes perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, other preferred stock, and a limited amount of loan loss reserves. Certain intangible assets are deducted in computing the Capital Ratios.

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

As of December 31, 2009, the Bank s Tier 1 Leverage Ratio was 7.54%, its Tier 1 Risk-Based Capital Ratio was 10.55% and its Total Risk-Based Capital Ratio was 11.81%. 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 (bps) 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.

FRB Requirements 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, 2009, on a consolidated basis, the Company s Tier 1 Leverage Ratio was 7.65%, its Tier 1 Risk-Based Capital Ratio was 10.71% and its Total Risk-Based Capital Ratio was 11.97%. Based upon the above ratios, the Company is considered well-capitalized for regulatory capital purposes.

Basel Accord U.S. bank regulatory authorities and international bank supervisory organizations, principally the Basel Committee on Banking Supervision (Basel Committee), continue to consider and to make changes to the risk-based capital adequacy framework, which could affect the appropriate capital guidelines to which the Company and the Bank are subject.

In 2005, the federal banking agencies issued an advance notice of proposed rulemaking concerning potential changes in the risk-based capital rules (Basel 1-A) that are designed to apply to and potentially reduce the risk capital requirements of bank holding companies, such as the Company, that are not among the core 20 or so largest U.S. bank holding companies (Core Banks). In December 2006, the FDIC issued a revised Interagency Notice of Proposed Rulemaking concerning Basel 1-A, which would allow banks and bank holding companies that are not among the Core Banks to either adopt Basel 1-A or remain subject to the existing risk-based capital rules. In July 2007, an interagency press release stated that the federal banking agencies have agreed to issue a proposed rule that would provide non-Core Banks with the option to adopt an approach consistent with the standardized approach of Basel II. This proposal would replace Basel 1-A. In December 2007, the federal banking agencies issued the final regulation that will implement Basel II for the Core Banks, permitting only the advanced approach. The final rule implementing Basel II reiterated that non-Core Banks would have the option to take the standardized approach. The rule also allows a banking organization s primary Federal supervisor to determine whether the application of the rule would not be appropriate in light of the bank s asset size, level of complexity, risk profile or scope of operations. The Bank is currently not required to comply with Basel II.

In July 2008, the federal banking agencies issued a proposed rule that would provide banking organizations that do not use the advanced approaches with the option to implement a new risk-based capital framework. This framework would adopt the standardized approach of Basel II for credit risk, the basic indicator approach of Basel II for operational risk and related disclosure requirements. While this proposed rule generally parallels the relevant approaches under Basel II, it diverges where United States markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. Comments on the proposed rule were due to the agencies by October 27, 2008, but a definitive final rule had not been issued as of December 31, 2009. The proposed rule, if adopted, will replace the agencies earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive (formerly referred to as the Basel I-A approach).

In December 2009, the Basel Committee on Banking Supervision released for comment a proposal to strengthen global capital regulations. The key elements of the proposal include raising the quality, consistency and transparency of the capital base, strengthening the risk coverage of the capital framework, introducing a leverage ratio that is different from the U.S. leverage ratio measures and promoting the build-up of capital buffers. The U.S. banking agencies are expected to issue a similar version of the proposal later this year. Although any U.S. proposal would apply to banking organizations subject to the Basel II regime to which the Company is not currently subject, the proposal might also impact the Company and other banking organizations. Additional proposals addressing these issues are expected in 2010.

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 $8.4 million at December 31, 2009 and $9.8 million at December 31, 2008. 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 unaffiliated persons, and do not represent more than normal credit risk.

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Interstate Banking

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

Gramm-Leach-Bliley Act

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

Under the G-L-B Act and its implementing regulations, financial holding companies may engage in any activity that (i) is financial in nature or incidental to a financial activity under the G-L-B Act or (ii) is complementary to a financial activity and does not impose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The G-L-B Act and its accompanying regulations specify certain activities that are financial in nature such as acting as principal, agent or broker for insurance; underwriting, dealing in or making a market in securities; and providing financial and investment advice. The new financial activities authorized by the G-L-B Act may also be engaged in by a financial subsidiary of a national or state bank, except for insurance or annuity underwriting, insurance company portfolio investments, real estate investments and development and merchant banking, which must be conducted in a financial holding company. The FRB and the Secretary of the Treasury have the authority to decide whether other activities are also financial in nature or incidental thereto, taking into account changes in technology, changes in the banking marketplace, competition for banking services and other pertinent factors. Although the Company may meet the qualifications to become a financial holding company, it has no current plans to elect such status.

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

In granting other types of financial institutions more flexibility, the G-L-B Act has increased 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.

Other Aspects of Federal and State Laws

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

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

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

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.

Recent Regulatory Developments

Financial Stability Plan On February 10, 2009, the Treasury announced the Financial Stability Plan (FS Plan), a comprehensive set of measures intended to shore up the U.S. financial system. The core elements of the plan include making bank capital injections, creating a public-private investment fund to buy troubled assets, establishing guidelines for loan modification programs and expanding the FRB lending program. The U.S. Treasury has indicated more details regarding the FS Plan are to be announced at a future date.

Temporary Debt Guaranty Program The FDIC s Temporary Liquidity Guarantee Program announce on October 14, 2008 also provided for FDIC guarantees of unsecured debt of depository institutions and certain holding companies. The Company elected to participate in the temporary debt guaranty program. Under the terms of this program, the Company was eligible to issue prior to June 30, 2009 up to $27.5 million of senior unsecured debt guaranteed by the FDIC until the earlier of the maturity of such debt or June 30, 2012. Such guaranteed debt would be subject to an annual assessment amount ranging from 50 to 100 basis points depending on its maturity date. The Company did not issue debt in 2009 and was not subject to an additional assessment under the temporary debt guarantee program.

American Recovery and Reinvestment Act of 2009 **-** On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted. ARRA is intended to provide a stimulus to the U.S. economy in light of the significant economic downturn. ARRA includes federal tax cuts, expansion of unemployment benefits and other social welfare provisions, and domestic spending in education, healthcare, and infrastructure, including the energy structure. ARRA also includes numerous non-economic recovery related items, including a limitation on executive compensation in federally aided financial institutions. Under ARRA, an institution will be subject to a number of restrictions and standards through-out the period in which any obligation arising from financial assistance provided under TARP remains outstanding.

Homeowner Affordability and Stability Plan On February 18, 2009, President Obama announced the Homeowner Affordability and Stability Plan (HASP). HASP is intended to support a recovery in the housing market and ensure that workers can continue to pay off their mortgages through the following elements:

- Provide access to low-cost refinancing for responsible homeowners suffering from falling home prices.
- A $75.0 billion homeowner stability initiative to prevent foreclosure and help responsible families stay in their homes.
- Support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

Overdraft Protection On November 12, 2009, the FRB amended Regulation E, to limit the ability to assess overdraft fees for paying ATM and one-time debit card transactions that overdraw a consumer s account, unless the consumer opts into such payment of overdrafts. The new rule does not apply to overdraft services with respect to checks, ACH transactions, or recurring debit card transactions, or to the payment of overdrafts pursuant to a line of credit or a service that transfers funds from another account. We are required to provide to customers written notice describing our overdraft service, fees imposed, and other information, and to provide customers with a reasonable opportunity to opt in to the service. Before we may assess fees for paying discretionary overdrafts, a customer must affirmatively opt in, which could negatively impact our noninterest income.

Proposed Legislation and Regulatory Action

Financial regulatory reform continues to be a top priority for the Obama Administration. The U.S. House of Representatives (the House) passed the Wall Street Reform and Consumer Protection Act on Dec. 11, 2009. The U.S. Senate has not yet enacted legislation in this area. The Senate Banking Committee draft bill, Restoring American Financial Stability Act of 2009 is still in draft form and currently under discussion. Both legislative products focus on measures to improve financial stability, provide for more effective bank supervision, enhance the regulation of consumer financial products and services through the establishment of a Consumer Financial Protection Agency and allow for better coordination between regulatory agencies. The House s bill would establish a Systemic Dissolution Fund to help wind down financial institutions when necessary. The fund would be pre-funded by FDIC assessments on large financial companies with assets exceeding $50.0 billion, to pay for the resolution of a bank holding company, a systemically important financial company, an insurance company or any other financial company. The Senate Banking Committee s draft proposal has a similar resolution mechanism and sets the threshold at $10 billion or more.
New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation s financial institutions. The Company cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which the business may be affected by any new regulation or statute. In the current environment, the nature and extent of future legislative and regulatory changes affecting financial institutions are very unpredictable at this time.

Effect of Governmental Policy

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

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ITEM 1A. RISK FACTORS

Overview

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

Risks Related to Our Business

Recent negative developments in the financial services industry and U.S. and global credit markets may adversely impact our operations and results.

During 2008 and the first half of 2009, capital and credit markets experienced unprecedented levels of volatility and disruption. These negative developments in the capital markets have resulted in uncertainty in the financial markets in general and a significant economic downturn in 2009 which has continued into 2010. Loan portfolio performances have deteriorated at most institutions, including the Bank, resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. The competition for our deposits has increased significantly due to liquidity concerns at many of these same institutions. Stock prices of bank holding companies, like ours, have been negatively affected by the current condition of the financial markets, as has our ability, if needed, to raise capital or borrow in the debt markets compared to recent years. Additionally, there is a potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and financial institution regulatory agencies have been and are expected to continue to be aggressive in responding to concerns and trends identified in examinations, including the issuance of many formal enforcement actions. Negative developments in the financial services industry and the impact of new legislation in response to those developments have, and may continue to negatively impact our operations by restricting our business operations and imposing increased costs, and adversely impact our financial performance.

The continuation of adverse market conditions in the U.S. economy and the markets in which we operate could adversely impact us.

The continued deterioration of overall market conditions adversely affected our financial performance in 2009. A continued economic downturn or prolonged economic stagnation in the U.S. markets and our markets may have further negative impacts on our business. The failure of the U.S.