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SLADES FERRY BANCORP
Form 10-K
April 03, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES
----- EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

Commission file number 000-23904

SLADE'S FERRY BANCORP.

(Exact name of registrant as specified in its charter)

| | |
|------------------------------------------------------------------------------------------|-------------------------------------------------------------------|
| MASSACHUSETTS ----- (State or other jurisdiction of in Company or organization) | 04-3061936 ----- (I.R.S. Employer Identification Number) |
|------------------------------------------------------------------------------------------|-------------------------------------------------------------------|

| | |
|----------------------------------------------------------------------------------------------------------|------------------------------|
| 100 Slade's Ferry Avenue Somerset, Massachusetts ----- (Address of principal executive offices) | 02726 ----- (Zip Code) |
|----------------------------------------------------------------------------------------------------------|------------------------------|

Registrant's telephone number, including area code: (508) 675-2121

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

Securities registered pursuant to Section 12(g) of the Act: Common Stock,
\$.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as
defined in Rule 405 of the Securities Act.

Yes [] No [X]

Indicate by check mark if the registrant is not required to file reports
pursuant to Section 13 or Section 15(d) of the Act.

Yes [] No [X]

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 and (2) has been subject to such
filing requirements for the past 90 days.

Yes [X] No []

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
statements incorporated by reference in Part III of this Form 10-K or any
amendment to this form 10-K. [X]

Indicate by check mark whether the registrant is a large accelerated filer,
an accelerated filer, or a non-accelerated filer. See definition of
"accelerated filer and large accelerated filer" in rule 12b-2 of the
Exchange Act. (Check one):

Large Accelerated Filer [] Accelerated Filer [] Non Accelerated Filer
[X]

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

Yes [] No [X]

The aggregate market value of the voting stock of Slade's Ferry Bancorp., held by nonaffiliates of the registrant as of June 30, 2005 was approximately \$66,016,000.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant's Proxy Statement for the 2006 Annual Meeting of Shareholders to be held on May 17, 2006 is incorporated by reference into Part III of this Form 10-K.

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PART I

FORWARD-LOOKING STATEMENTS

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding the strength of the company's capital and asset quality. Such statements may be identified by words such as "believes," "will," "expects," "project," "may," "could," "developments," "strategic," "launching," "opportunities," "anticipates," "estimates," "intends," "plans," "targets" and similar expressions. These statements are based upon the current beliefs and expectations of Slade's Ferry Bancorp.'s management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements as a result of numerous factors.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

- (1) enactment of adverse government regulation;
- (2) competitive pressures among depository and other financial institutions may increase significantly and have an effect on pricing, spending, third-party relationships and revenues;
- (3) the strength of the United States economy in general and specifically the strength of the New England economies may be different than expected, resulting in, among other things, a deterioration in overall credit quality and borrowers' ability to service and repay loans, or a reduced demand for credit, including the resultant effect on our loan portfolio, levels of charge-offs and non-performing loans and allowance for loan losses;
- (4) changes in the interest rate environment may reduce interest margins and adversely impact net interest income; and
- (5) changes in assumptions used in making such forward-looking statements.

Should one or more of these risks materialize or should underlying beliefs or assumptions prove incorrect, Slade's Ferry Bancorp.'s actual results could differ materially from those discussed.

All subsequent written and oral forward-looking statements attributable to Slade's Ferry Bancorp. or any person acting on its behalf are expressly

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qualified in their entirety by the cautionary statements set forth above. Slade's Ferry Bancorp. does not intend or undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

As used throughout this report, the terms "we," "our," "us," or the "Bank" or the "Company" refer to Slade's Ferry Bancorp. and its consolidated subsidiaries, unless context otherwise requires.

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ITEM 1

BUSINESS

GENERAL

Slade's Ferry Bancorp., a Massachusetts corporation, is a bank holding company headquartered in Somerset, Massachusetts with consolidated assets of \$585.9 million, consolidated net loans and leases of \$409.6 million, consolidated deposits of \$415.8 million and consolidated shareholders' equity of \$48.9 million as of December 31, 2005. We conduct our business principally through our wholly-owned subsidiary, Slade's Ferry Trust Company (referred to herein as the "Bank"), a Massachusetts-chartered trust company. As a bank holding company, we are subject to the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the rules and regulations of the Federal Reserve Board (the "FRB") under the BHCA. We are additionally subject to the provisions of the Massachusetts General Laws applicable to commercial bank and trust companies and other depository institutions and their holding companies and applicable regulations of the Massachusetts Division of Banks (the "Division"). We are also subject to the rules and regulations of the Securities and Exchange Commission (the "SEC") as our common stock is registered with the SEC and is quoted on the Nasdaq Capital Market. The Bank's deposit accounts are insured up to applicable limits by the Bank Insurance Fund of the Federal Deposit Insurance Company (the "FDIC"). The Bank is subject to extensive regulation, examination and supervision by the Division as its primary corporate regulator, and by the FDIC as its deposit insurer and primary federal regulator. Any change in such laws and regulations, whether by the Division, the FDIC, the FRB or the SEC or through legislation, could have a material adverse impact on our operation.

Our main office is located at 100 Slade's Ferry Avenue, Somerset, Massachusetts, 02726, and our telephone number is (508) 675-2121. Slade's Ferry Bancorp. was organized for the purpose of becoming the holding company of the Bank. Slade's Ferry Bancorp.'s acquisition of the Bank was completed on April 1, 1990.

We had consolidated asset growth of \$36.5 million or 6.6% and our level of deposits increased by \$15.9 million, or by 4.0%, during 2005. Aside from deposits, we increased borrowings from the Federal Home Loan Bank of Boston (the "FHLB") by \$17.6 million. This activity funded an increase in loans totaling \$47.3 million or 13.1%, and an increase in investments totaling \$1.9 million or 1.6%.

While we evaluate opportunities to acquire other banks or bank facilities as they arise and may in the future acquire other banks, financial institutions, or bank facilities, we are not currently engaged in any such acquisition.

We are committed to the philosophy of serving the needs of customers within

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our market area. We believe that our comprehensive retail, small business, and commercial real estate products enable us to compete effectively. We do not have any major target accounts, nor do we derive a material portion of our deposits from any single depositor. We concentrate our operations in the area of retail banking and we service the needs of the local communities. Our loans are not concentrated within any single industry or group of related industries that would have any possible adverse effect on our business.

We currently have nine full service banking facilities plus a drive up complex extending east from Seekonk, Massachusetts to Fairhaven, Massachusetts. These facilities service numerous communities in Southeastern Massachusetts and contiguous areas of Rhode Island. We also provide limited banking services at the Somerset High School in Somerset, Massachusetts. We opened our newest facility, located in Assonet, Massachusetts in early 2005. This branch is a state-of-the-art, full-service banking office, designed to provide superior customer convenience and service. We own and operate eight full service automated teller machines ("ATM") and one ATM dispenser.

The Bank maintains three wholly-owned subsidiaries. Two of these, Slade's Ferry Securities Corporation ("SFSC"), and Slade's Ferry Securities Corporation II ("SFSCII") are Massachusetts securities corporations on which, under current Massachusetts law, income is taxed at 1.32%, as compared to the Massachusetts bank taxation rate of 10.5%. In exchange for this lower tax rate, the assets of any Massachusetts security Corporation are limited to certain investment securities, including United States Treasury and agency securities, obligations of government-sponsored entities, mortgage-backed investments, corporate debt securities and marketable equity securities. Investment securities with book values totaling \$15.8 million and \$32.9 million were held at SFSC and SFSC II, respectively, at December 31, 2005.

Slade's Ferry Realty Trust ("SFRT") owns and manages our land and buildings.

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Slade's Ferry Loan Company ("SFLC") was a Rhode Island Company founded for the purpose of generating loans in the State of Rhode Island. As the Bank has received authorization to generate loans in Rhode Island directly, SFLC was dissolved in early 2005.

Slade's Ferry Statutory Trust I, a Connecticut statutory trust was formed on March 17, 2004 by the Company.

Our major customer accounts as of December 31, 2005 consist of approximately 29,940 personal savings, checking and money market accounts, and approximately 6,800 personal and commercial certificates of deposit and individual retirement accounts. Our commercial base consists of approximately 3,240 checking, money market, and corporate accounts.

As we grew in 2005, we remained committed to customer service. We continue to upgrade the systems utilized on the teller platform and in customer service areas to allow employees to serve customers more efficiently.

SERVICES

We engage in a broad range of banking activities, including demand, savings and time deposits, related personal and commercial checking account services, real estate mortgages, commercial and installment lending, payroll services, money orders, travelers checks, Visa, MasterCard, debit card, safe

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deposit rentals and automatic teller machines. We also offer certain non-traditional banking services including investments, life insurance, annuities, and cash management services and we also provide a range of internet-based services for both consumer and commercial customers.

LENDING ACTIVITIES

Our loan portfolio consists primarily of residential and commercial real estate, construction and land development, commercial, home equity lines of credit and consumer loans originated primarily in our market area. There are no foreign loans outstanding. Interest rates charged by the Bank on loans are affected principally by the demand for such loans, the supply of money available for lending purposes and the rates offered by its competitors. These factors are affected by general and economic conditions, monetary policies of the federal government, including the FRB, legislative tax policies and governmental budgetary matters. We originate residential mortgage loans, equity lines of credit, fixed-rate equity loans, commercial business loans, consumer loans and commercial real estate loans. Total net loans were 69.9% of total assets at December 31, 2005, as compared to 65.9% of total assets at December 31, 2004. See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation", for detailed portfolio information.

Multi-Family and Commercial Real Estate Lending

We originate multi-family and commercial real estate loans that are generally secured by five or more unit apartment buildings and properties used for business purposes such as small office buildings, restaurants or retail facilities primarily located in our primary market area. Our multi-family and commercial real estate underwriting policies provide that such real estate loans may be made in amounts of up to 80% of the appraised value of the property, subject to our current loans-to-one-borrower limit of \$9.5 million at December 31, 2005. Our multi-family and commercial real estate loans are generally made with terms of up to 20 years and are offered with interest rates that adjust periodically. In reaching a decision on whether to make a multi-family or commercial real estate loan, we consider the net operating income of the property, the borrower's expertise, credit history and profitability and the value of the underlying property. We have generally required that the properties securing these real estate loans have debt service coverage ratios (earnings before debt service to debt service requirements) of at least 1.20 times. Environmental impact surveys are generally required for all commercial real estate loans. Generally, all multi-family and commercial real estate loans made to companies, partnerships and other business entities require personal guarantees by the principals. We may choose not to require a personal guarantee on such loans depending on the creditworthiness of the borrower and the amount of the down payment and other mitigating circumstances.

Loans secured by multi-family and commercial real estate properties generally involve larger principal amounts and a greater degree of risk than one-to-four family residential mortgage loans. Because payments on loans secured by multi-family and commercial real estate properties are often dependent on successful operation or management of the

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properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. We seek to minimize these risks through our underwriting standards.

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Multi-family and commercial real estate loans totaled \$213.8 million and comprised 51.6% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the multi-family and commercial real estate loan portfolio totaled \$192.8 million, or 52.6% of total gross loans.

Residential Lending

We currently offer fixed-rate, one-to-four family mortgage loans with terms from 10 to 30 years and a number of adjustable-rate mortgage ("ARM") loans with terms of up to 30 years and interest rates which adjust every one or three years from the outset of the loan. The interest rates for the ARM loans are generally indexed to the applicable Constant Maturity Treasury ("CMT") Index, or other comparable indices. Our ARM loans generally provide for periodic (not more than 2%) and overall (not more than 6%) caps on the increase or decrease in the interest rate at any adjustment date and over the life of the loan.

The origination of adjustable-rate residential mortgage loans and short-term fixed-rate mortgage loans, as opposed to 30-year, fixed-rate residential mortgage loans, generally helps reduce our exposure to increases in interest rates. However, adjustable-rate loans generally pose credit risks not inherent in fixed-rate loans, primarily because as interest rates rise, the underlying payments of the borrower rise, thereby increasing the potential for default. Periodic and lifetime caps on interest rate increases help to reduce the risks associated with adjustable-rate loans but also limit the interest rate sensitivity of such loans. The continued period of low market interest rates has been the impetus for the Bank's customers to continue to finance home purchases with fixed-rate loans or to refinance ARM loans into fixed-rate loans.

Generally, we originate one-to-four family residential mortgage loans in amounts of up to 95% of the appraised value or selling price of the property securing the loan, whichever is lower. Certain loans in our "First-Time Home Buyer" program allow for a 97% loan-to-value ("LTV") ratio. Private mortgage insurance ("PMI") is required for loans with a LTV ratio of greater than 80%. Mortgage loans we originate generally include due-on-sale clauses, which provide us with the contractual right to deem the loan immediately due and payable in the event the borrower transfers ownership of the property without our consent. Due-on-sale clauses are an important means of adjusting the yields on our fixed-rate mortgage loan portfolio and we have generally exercised our rights under these clauses. We require fire, casualty, title, and, in certain cases, flood insurance on all properties securing real estate loans we make.

In an effort to provide financing for moderate income and first-time homebuyers, we offer Federal Housing Authority ("FHA") and Veterans Administration ("VA") loans and we have our own First-Time Home Buyer loan program. These programs offer residential mortgage loans to qualified individuals. These loans are offered with adjustable and fixed rates of interest and terms of up to 30 years. Such loans may be secured by a one-to-four family residential property, in the case of FHA and VA loans, and must be secured by a single-family, owner-occupied unit in the case of First-Time Home Buyer loans. These loans are originated using modified underwriting guidelines, in the case of FHA and VA loans, and the same underwriting guidelines as our other one-to-four family mortgage loans in the case of First-Time Home Buyer loans. Such loans may be originated in amounts of up to 97% of the lower of the property's appraised value or the sale price. Private mortgage insurance is required on all such loans with loan to values in excess of 80%.

We generally underwrite our residential real estate loans to comply with secondary market standards established by the Federal National Mortgage

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Association. Although loans are underwritten to standards that make them readily salable, we have not chosen to sell these loans, rather to maintain them in portfolio, consistent with our income and interest rate risk management targets.

Residential real estate loans totaled \$120.3 million and comprised 29.1% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the residential real estate loan portfolio totaled \$97.5 million, or 26.6% of total gross loans.

Commercial Loans

Our commercial business loan portfolio consists of loans and lines of credit predominantly collateralized by inventory, furniture and fixtures, and accounts receivable. In assessing the collateral for these loans, management applies a 50% liquidation value to inventories; 25% to furniture, fixtures and equipment; and 70% to accounts receivable less than 90 days of invoice date. Like commercial real estate loans, the successful repayment of these loans is dependent on the

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operations of the business to which the loan is made. Accordingly, these loans carry a higher level of credit risk than loans secured by real estate. To alleviate some of this risk, credit enhancements, such as personal guarantees or additional collateral are often taken.

Commercial loans totaled \$38.1 million and comprised 9.2% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the commercial loan portfolio totaled \$26.6 million, or 7.3% of total gross loans.

Construction Lending

We originate fixed-rate construction loans for the development of one-to-four family residential properties, primarily located in our primary market area. Although we do not generally make loans secured by raw land, our policies permit the origination of such loans. Construction loans are generally offered to experienced local developers operating in our primary market area and to individuals for the construction of their primary residence. Construction loans are generally offered with terms of up to 24 months and may be made in amounts of up to 70% of the appraised value of the property, as improved. In the case of construction loans to individuals for the construction of their primary residence, loans up to 90% of the appraisal value may be made. Loans made to individuals are generally written on a construction-to-permanent basis. Land loans of up to 80% of the appraised value may be made. Construction loan proceeds are disbursed periodically in increments as construction progresses and as inspections by an independent construction specialist warrant. Generally, if the borrower is a company, partnership or other business entity, personal guarantees by the principals are required for all construction loans.

Construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction compared to the estimated cost (including interest) of construction and other assumptions, including the estimated time to sell residential properties. If the estimate of value proves to be inaccurate, we may be confronted with a project, when completed, having a value which is insufficient to assure full repayment.

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Construction and land development loans totaled \$21.5 million and comprised 5.2% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the construction and land development loan portfolio totaled \$24.2 million, or 6.6% of total gross loans.

Home Equity Lines of Credit

Substantially all of our home equity lines of credit are secured by second mortgages on owner-occupied, one-to-four family residences located in our primary market area. Our home equity lines of credit generally have interest rates, indexed to the Wall Street Journal Prime Rate, that adjust on a monthly basis. Home equity lines of credit generally have an 18% lifetime limit on interest rates. Generally, the maximum combined loan-to-value ratio on home equity lines of credit is 80%. The underwriting standards we employ for home equity lines of credit include a determination of the applicant's credit history and an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan and the value of the collateral securing the loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment and, additionally, from any verifiable secondary income. Creditworthiness of the applicant is a primary consideration.

Home equity lines of credit totaled \$17.9 million and comprised 4.3% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the home equity line of credit portfolio totaled \$23.1 million, or 6.3% of total gross loans.

Consumer Lending

Loans secured by rapidly depreciable assets such as recreational vehicles and automobiles entail greater risks than one-to-four family, residential mortgage loans. In such cases, repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance, since there is a greater likelihood of damage, loss or depreciation of the underlying collateral. Further, consumer loan collections on these loans are dependent on the borrower's continuing financial stability and, therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Finally, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans in the event of a default. Accordingly, we originate consumer loans typically based on the borrower's ability to repay the loan through continued financial stability. We endeavor to minimize risk by reviewing the borrower's repayment history on past debts, and

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assessing the borrower's ability to meet existing obligations on the proposed loans. Because of the proliferation of manufacturers' discount financing and automobile leasing, origination of automobile loans has diminished significantly in the last five years, accounting for the continued decrease in consumer loans as a percentage of our loan portfolio.

Consumer loans totaled \$2.6 million and comprised 0.6% of the total gross loan portfolio at December 31, 2005. At December 31, 2004, the consumer loan portfolio totaled \$2.5 million, or 0.7% of total gross loans.

Loan Approval Procedures and Authority

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The Bank's Board of Directors establishes the Bank's lending policies and loan approval limits. The Bank's Board of Directors has established a Loan Committee that considers and approves all loans within its designated authority as established by the Board. In addition, the Bank's Board of Directors has authorized certain officers to consider and approve all loans within their designated authority as established by the Board. The President and Chief Executive Officer and Senior Vice President have authority to approve loans to \$250,000, and the Loan Committee has authority to approve loans to \$500,000. For loans above \$500,000, Executive Committee or full Board approval is necessary.

INVESTING ACTIVITIES

We utilize our investment portfolio as a temporary means of warehousing liquidity until the funds can be lent. The investment portfolio also serves to secure certain deposits and borrowings. We manage the investment portfolio to optimize earnings, while using the portfolio as a tool in managing interest rate risk. We use an independent investment advisor to assist us in our portfolio management function.

We utilize both a "held-to-maturity" category and an "available-for-sale" category, as defined in Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities", to manage the investment portfolio. Our investment policy requires Board approval before a trading account can be established. The held-to-maturity category was originally established for holding high-yielding municipal securities. Beginning in the third quarter of 2004, certain mortgage-backed securities designated as collateral for FHLB advances were also designated as held-to-maturity. Management has the ability and intent to hold these securities to their contractual maturity. Held-to-maturity securities totaled \$29.3 million at December 31, 2005, while available-for-sale securities totaled \$94.3 million as compared to \$37.8 million and \$83.9 million, respectively, at December 31, 2004.

We primarily utilize obligations of U.S. Government-sponsored enterprises and mortgage-backed securities as investment vehicles. High-quality corporate bonds and municipal securities are purchased when an exceptional opportunity to enhance investment yields arises. Purchases of these investments are limited to securities that carry a rating of "Baa1" (Moody's) or "BBB+" (Standard and Poor's), in order to control credit risk within the investment portfolio. Among other investment criteria, it is management's goal to maintain a total portfolio duration of less than 5 years. At December 31, 2005, the portfolio duration was estimated at 2.80 years, which is within the established portfolio duration limit.

Excess cash is sold on an overnight basis into federal funds or overnight deposits at the FHLB. At December 31, 2005 federal funds sold totaled \$2.2 million or 0.4% of total assets, as compared to \$18.8 million, or 3.4% of total assets at December 31, 2004.

Under Massachusetts Law, the Bank is permitted to invest in marketable equity securities. Management views equity securities as a source of current income with tax advantages, as well as a source of capital gain income, given appreciation in the portfolio. Limits on asset quality, holding size, overall portfolio size and composition are in place to protect us from undue market risk. All equity securities are classified as available-for-sale.

DEPOSIT ACTIVITIES

We seek to develop relationships with our customers in order to become the customer's primary bank. We have developed programs that stress multiple account relationships in order to increase the level of "core deposits" in

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our portfolio. Management views a customer's checking account as the primary relationship account and, accordingly, emphasizes the growth of checking accounts in its strategic plans. Aside from checking accounts being a consistent, low-cost source of funds, they provide a source of non-interest income in the form of service charges and insufficient funds fees.

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Deposits are obtained from individuals and from small and medium-sized businesses in the local market area. Our customer base is diverse, and accordingly different product suites are offered to different groups of customers. The suites range from accounts that serve the basic service needs of any customer, such as free checking and statement savings accounts, to our "Coastal" product suite, which addresses the particular needs of high-balance customers. Additionally, small and medium-sized businesses have suites of products that address their particular needs. We also attract deposits from municipalities and other government agencies. We do not solicit or accept brokered deposits. We offer a full line of deposit products including checking and NOW accounts, savings accounts, money market accounts, and certificates of deposit. We offer debit cards for our checking and savings accounts.

Customers have access to deposit funds at any of our ten office locations, all of which are equipped with Automated Teller Machines. Additionally, the Bank is a member of the NYCE Network, enabling customers to have access to their funds worldwide. We also provide balance inquiry and funds transfer telephonically. Our website, www.sladesferry.com, provides customers with the ability to manage their accounts and pay bills online. Business customers who utilize our cash management program have the ability to transfer funds and originate wire transfers or ACH transactions through the website as well.

As a general rule, management systematically reviews the deposit accounts it offers to determine if the products meet both the customers' needs and our asset/liability management goals. This review is the responsibility of the Pricing Committee, which meets weekly to determine products and pricing practices consistent with overall earnings and growth goals. The Pricing Committee establishes deposit interest rates based on a variety of factors, including local economy, market interest rates, competitors' interest rates, and the need to fund loan demand. We set rates to be competitive, but not necessarily the highest rates in our market area. As competition for deposits has intensified with the larger financial institutions in our market area, we introduced the use of off-maturity "special" certificate accounts. We actively market our other products to new depositors garnered through the use of promotions, in order to cross-sell additional products and services, and thereby establish a continued banking relationship.

In order to offset the potentially adverse effects of early withdrawal, we generally charge an early withdrawal penalty on certificates of deposit 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 an original maturity of greater than one year. Interest credited to a certificate account during any term may be withdrawn without penalty at any time during the term. Upon renewal of a certificate account, only interest credited during the renewal term may be withdrawn without penalty.

NON-DEPOSIT INVESTMENT PRODUCTS

We offer a variety of mutual funds, annuities, and insurance products offered through third-party sales arrangements with Linsco Private Ledger,

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Inc. and the Savings Bank Life Insurance Company of Massachusetts ("SBLI").

BORROWING ACTIVITIES

In order to fund additional asset growth, we have the ability to borrow at the FHLB of Boston. The FHLB limits borrowings to 30% of assets, and limits FHLB stock purchases to 4.5% of total borrowings. These borrowings are collateralized by our residential loan portfolio, certain commercial real estate loans, and certain obligations and mortgage-backed securities of government-sponsored enterprises. Management views borrowing as not only a funding mechanism, but as a tool to manage the levels of interest rate risk inherent in the balance sheet. In addition, we maintain borrowing lines of credit with correspondent banks to meet short-term liquidity needs.

During this period we have utilized FHLB advances to enhance our interest rate risk position. In prior years, we had used amortizing advances to "match-fund" certain commercial loans. As management has taken a whole-balance sheet approach to interest rate risk management, the use of matched funding strategies has decreased, in favor of the use of bullet and community development advances, deployed in a ladder approach. Because the FHLB attaches significant prepayment penalties to long-term advances, management does not anticipate prepayment of the amortizing advances.

COMPETITION

The banking business in our market area is highly competitive. We actively compete for both loans and deposits with local branches of nationwide and regional banks, as well as local banks and credit unions. We also compete with consumer mortgage and finance companies, financing subsidiaries of durable goods manufacturers, and insurance

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companies. Many of the major commercial banks or other affiliates in our service areas offer services such as international banking and trust services that we do not currently offer directly.

In order to expand our market area, we opened our newest facility located in Assonet, Massachusetts in early 2005. This branch is a state-of-the-art, full-service banking office, designed to provide superior customer convenience and service. We believe that the addition of this branch will add to the diversity in our loan portfolio and add a new pool of potential depositors.

EMPLOYEES

At December 31, 2005, we had 116 full-time and 33 part-time employees. We believe that employee relations are good, and there are no known disputes between management and employees.

All employees are eligible to participate in our Retirement Savings 401(k) Plan and Profit Sharing Plan. Additionally, certain officers may participate in the Slade's Ferry Bancorp. Stock Option Plan, and certain executive officers may participate in a supplemental executive retirement program.

Our performance-based incentive programs for officers and employees have supported, and will continue to support our growth, by giving employees a stake in our overall performance and for balancing profit, growth and productivity.

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HOLDING COMPANY REGULATION

FEDERAL REGULATION

Capital Requirements

The FRB has adopted capital adequacy guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company and in analyzing applications to it under the BHCA. The FRB capital adequacy guidelines generally require bank holding companies to maintain total capital equal to 8% of total risk-adjusted assets, with at least one-half of that amount consisting of Tier I, or core capital, and up to one-half of that amount consisting of Tier II, or supplementary capital. Tier I capital for bank holding companies generally consists of the sum of common shareholders' equity and perpetual preferred stock (subject in the case of the latter to limitations on the kind and amount of such stocks which may be included as Tier I capital), less goodwill and, with certain exceptions, intangibles. Tier II capital generally consists of hybrid capital instruments; perpetual preferred stock which is not eligible to be included as Tier I capital; term subordinated debt and intermediate-term preferred stock; and, subject to limitations, general allowances for loan losses. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no additional capital) for assets such as cash to 100% for the bulk of assets which are typically held by a bank holding company, including multi-family residential and commercial real estate loans, commercial business loans and consumer loans. Single-family residential first mortgage loans which are not past-due (90 days or more) or non-performing and which have been made in accordance with prudent underwriting standards are assigned a 50% level in the risk-weighting system, as are certain privately-issued mortgage-backed securities representing indirect ownership of such loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics.

In addition to the risk-based capital requirements, the FRB requires bank holding companies to maintain a minimum leverage capital ratio of Tier I capital to total assets of 3.0%. Total assets for this purpose does not include goodwill and any other intangible assets and investments that the FRB determines should be deducted from Tier I capital. The FRB has announced that the 3.0% Tier I leverage capital ratio requirement is the minimum for the top-rated bank holding companies without any supervisory, financial or operational weaknesses or deficiencies or those that are not experiencing or anticipating significant growth. Other bank holding companies are expected to maintain Tier I leverage capital ratios of at least 4.0% to 5.0% or more, depending on their overall condition.

The Company is in compliance with the above-described FRB regulatory capital requirements.

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Activities

The BHCA prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank, or increasing such ownership or control of any bank, without prior approval of the FRB. No approval under the BHCA is required, however, for a bank holding company already owning or controlling 50% of the voting shares of a bank to acquire additional shares of such bank.

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The BHCA also prohibits a bank holding company, with certain exceptions, from acquiring more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than banking or managing or controlling banks. Under the BHCA, the FRB is authorized to approve the ownership of shares by a bank holding company in any company, the activities of which the FRB has determined to be so closely related to banking or to managing or controlling banks as to be a proper incident thereto. In making such determinations, the FRB is required to weigh the expected benefit to the public, such as greater convenience, increased competition or gains in efficiency, against the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.

In addition, a bank holding company that does not qualify and elect to be treated as a financial holding company under the Gramm-Leach-Bliley Financial Services Modernization Act is generally prohibited from engaging in, or acquiring, direct or indirect control of any company engaged in non-banking activities. One of the principal exceptions to this prohibition is for activities found by the FRB to be so closely related to banking or managing or controlling banks as to be permissible. Bank holding companies that do qualify as a financial holding company may engage in activities that are financial in nature or incident to activities which are financial in nature. Bank holding companies may qualify to become a financial holding company if it meets certain criteria set forth by the FRB.

Beginning June 1, 1997, the Interstate Banking Act permitted federal banking agencies to approve merger transactions between banks located in different states, regardless of whether the merger would be prohibited under the law of the two states. The Interstate Banking Act also permitted a state to "opt in" to the provisions of the Interstate Banking Act before June 1, 1997, and permitted a state to "opt out" of the provisions of the Interstate Banking Act by adopting appropriate legislation before that date. Accordingly, beginning June 1, 1997, the Interstate Banking Act permitted a bank, such as the Bank, to acquire an institution by merger in a state other than Massachusetts unless the other state had opted out of the Interstate Banking Act. The Interstate Banking Act also authorizes de novo branching into another state if the host state enacts a law expressly permitting out of state banks to establish such branches within its borders.

MASSACHUSETTS REGULATION

The Company as a Massachusetts-chartered corporation is governed by the Massachusetts Business Company Law and the Company's Articles of Organization and Bylaws. Under the Massachusetts banking laws, a company owning or controlling two or more banking institutions, including a savings bank, is regulated as a bank holding company. The Company or the Bank would become a Massachusetts bank holding company if the Company acquired a second banking institution and operated it separately from the Bank or the Bank acquired a banking institution.

ACQUISITION OF THE COMPANY OR THE BANK

Federal Restrictions

Under the federal Change in Bank Control Act, any person (including a company), or group acting in concert, seeking to acquire control of the Company or the Bank will be required to submit prior notice to the FRB. Under the Change in Bank Control Act, the FRB has 60 days within which to act on such notices, taking into consideration factors, including the financial and managerial resources of the acquirer, the convenience and needs of the communities served by the Company and the Bank, and the anti-trust effects of the acquisition. The term "control" is defined generally

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under the BHCA to mean the ownership or power to vote 25% or more of any class of voting securities of an institution or the ability to control in any manner the election of a majority of the institution's directors. Additionally under the Bank Merger Act sections of the Federal Deposit Insurance Act, the prior approval of an insured institution's primary federal regulator is required for an insured institution to merge with or transfer assets to another insured institution or an uninsured institution.

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BANK REGULATION

MASSACHUSETTS BANKING REGULATION

General

The Bank is subject to Massachusetts statute and the rules and regulations of the Division establishing the powers of the Bank, investment limitations and minimum standards relative to the security and protection of the Bank for the benefit of Bank employees and the general public.

Loans-to-One-Borrower Limitations

With specified exceptions, the total obligations of a single borrower to a Massachusetts-chartered commercial bank and trust company may not exceed 20% of shareholders' equity. A commercial bank and trust company may lend additional amounts up to 100% of its retained earnings account if secured by collateral meeting the requirements of the Massachusetts banking laws. The Bank currently complies with applicable loans-to-one-borrower limitations.

Dividends

Under the Massachusetts banking laws, a commercial bank and trust company may, subject to several limitations, declare and pay a dividend on its capital stock out of the Bank's net profits. A dividend may not be declared, credited or paid by a stock trust company so long as there is any impairment of capital stock. No dividend may be declared on the Bank's common stock for any period other than for which dividends are declared upon preferred stock, except as authorized by the Commissioner of the Division. The approval of the Commissioner is also required for a commercial bank and trust company to declare a dividend, if the total of all dividends declared by the commercial bank and trust company in any calendar year shall exceed the total of its net profits for that year combined with its retained net profits of the preceding two years, less any required transfer to surplus or a fund for the retirement of any preferred stock.

In addition, federal law may also limit the amount of dividends that may be paid by the Bank. See "- Federal Banking Regulation - Prompt Corrective Action."

Examination and Enforcement

The Division is required to periodically examine commercial bank and trust companies at least once every calendar year or at least once each 18-month period if the commercial bank and trust company qualifies as well capitalized under the prompt corrective action provisions of the Federal Deposit Insurance Act. See "- Federal Banking Regulation - Prompt Corrective Action."

Community Reinvestment Act

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The Bank is subject to provisions of the Massachusetts Community Reinvestment Act, which are similar to those imposed by the federal Community Reinvestment Act with the exception of the assigned exam ratings. Massachusetts banking law provides for an additional exam rating of "high satisfactory" in addition to the federal Community Reinvestment Act ratings of "outstanding," "satisfactory," "needs to improve" and "substantial noncompliance." The Division is required to consider a bank's Massachusetts Community Reinvestment Act rating when reviewing the Bank's application to engage in certain transactions, including mergers, asset purchases and the establishment of branch offices or automated teller machines, and provides that such assessment may serve as a basis for the denial of any such application. The Massachusetts Community Reinvestment Act requires the Division to assess a bank's compliance and to make such assessment available to the public. The Bank's latest Massachusetts Community Reinvestment Act rating, from an exam dated July 18, 2005, was a rating of "Satisfactory."

FEDERAL BANKING REGULATION

Capital Requirements

FDIC regulations require Bank Insurance Fund-insured banks, such as the Bank, to maintain minimum levels of capital. The FDIC regulations define two classes of capital known as Tier 1 and Tier 2 capital.

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The FDIC regulations establish a minimum leverage capital requirement for banks in the strongest financial and managerial condition, with a rating of 1 (the highest examination rating of the FDIC for banks) under the Uniform Financial Institutions Rating System, of not less than a ratio of 3.0% of Tier 1 capital to total assets. For all other banks, the minimum leverage capital requirement is 4.0%, unless a higher leverage capital ratio is warranted by the particular circumstances or risk profile of the depository institution.

The FDIC regulations also require that banks meet a risk-based capital standard. The risk-based capital standard requires the maintenance of a ratio of total capital (which is defined as the sum of Tier 1 capital and Tier 2 capital) to risk-weighted assets of at least 8% and a ratio of Tier 1 capital to risk-weighted assets of at least 4%. In determining the amount of risk-weighted assets, all assets, plus certain off balance sheet items, are multiplied by a risk-weight of 0% to 100%, based on the risks the FDIC believes are inherent in the type of asset or item.

The federal banking agencies, including the FDIC, have also adopted regulations to require an assessment of an institution's exposure to declines in the economic value of a bank's capital due to changes in interest rates when assessing the Bank's capital adequacy. Under such a risk assessment, examiners will evaluate a bank's capital for interest rate risk on a case-by-case basis, with consideration of both quantitative and qualitative factors.

Institutions with significant interest rate risk may be required to hold additional capital. The agencies also issued a joint policy statement providing guidance on interest rate risk management, including a discussion of the critical factors affecting the agencies' evaluation of interest rate risk in connection with capital adequacy. The Bank was considered "well-capitalized" under FDIC guidelines at December 31, 2005.

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Activity Restrictions on State-Chartered Banks

Section 24 of the Federal Deposit Insurance Act ("FDIA"), as amended, which was added by the Federal Deposit Insurance Company Improvement Act of 1991 ("FDICIA"), generally limits the activities and investments of state-chartered FDIC insured banks and their subsidiaries to those permissible for national banks and their subsidiaries, unless such activities and investments are specifically exempted by Section 24 or consented to by the FDIC.

Section 24 provides an exception for investments by a bank in common and preferred stocks listed on a national securities exchange or the shares of registered investment companies if:

- (1) The Bank held such types of investments during the 14-month period from September 30, 1990 through November 26, 1991;
- (2) The state in which the Bank is chartered permitted such investments as of September 30, 1991; and
- (3) The Bank notifies the FDIC and obtains approval from the FDIC to make or retain such investments. Upon receiving such FDIC approval, an institution's investment in such equity securities will be subject to an aggregate limit up to the amount of its Tier 1 capital.

The Bank received approval from the FDIC to retain and acquire such equity investments subject to a maximum permissible investment equal to the lesser of 100% of the Bank's Tier 1 capital or the maximum permissible amount specified by the FDIA. Section 24 also provides an exception for majority owned subsidiaries of a bank, but Section 24 limits the activities of such subsidiaries to those permissible for a national bank, permissible under Section 24 of the FDIA and the FDIC regulations issued pursuant thereto, or as approved by the FDIC.

Before making a new investment or engaging in a new activity not permissible for a national bank or not otherwise permissible under Section 24 of the FDIC regulations thereunder, an insured bank must seek approval from the FDIC to make such investment or engage in such activity. The FDIC will not approve the activity unless the Bank meets its minimum capital requirements and the FDIC determines that the activity does not present a significant risk to the FDIC insurance funds.

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Enforcement

The FDIC has extensive enforcement authority over insured state-chartered commercial bank and trust companies, including the Bank. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease and desist orders and to remove directors and officers. In general, these enforcement actions may be initiated in response to violations of laws and regulations and to unsafe or unsound practices.

The FDIC is required, with certain exceptions, to appoint a receiver or conservator for an insured state bank if that bank is "critically undercapitalized." For this purpose, "critically undercapitalized" means having a ratio of tangible capital to total assets of less than 2%. The FDIC may also appoint a conservator or receiver for a state bank on the basis of the institution's financial condition or upon the occurrence of certain

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events.

Deposit Insurance

Pursuant to FDICIA, the FDIC established a system for setting deposit insurance premiums based upon the risks a particular institution poses to its deposit insurance fund. Under the risk-based deposit insurance assessment system, the FDIC assigns an institution to one of three capital categories based on the institution's financial information, as of the most recent quarterly report filed with the applicable bank regulatory agency prior to the assessment period. The three capital categories are: (1) well capitalized, (2) adequately capitalized and (3) undercapitalized, using capital ratios that are substantially similar to the prompt corrective action capital ratios discussed below. See "-Federal Banking Regulation - Prompt Corrective Action" below. The FDIC also assigns an institution to a supervisory subgroup based on a supervisory evaluation provided to the FDIC by the institution's primary federal regulator and information that the FDIC determines to be relevant to the institution's financial condition and the risk posed to the deposit insurance funds (which may include, if applicable, information provided by the institution's state supervisor). An institution's assessment rate depends on the capital category and supervisory category to which it is assigned. Any increase in insurance assessments could have an adverse effect on the earnings of insured institutions, including the Bank.

Under the FDIA, the FDIC may terminate the insurance of an institution's deposits upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Transactions with Affiliates of the Bank

Transactions between an insured bank, such as the Bank, and any of its affiliates are governed by Sections 23A and 23B of the Federal Reserve Act (the "FRA"). An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the Bank. A subsidiary of a bank that is not also a depository institution is not treated as an affiliate of the Bank for purposes of Sections 23A and 23B.

Section 23A:

- * limits the extent to which the Bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such bank's capital stock and retained earnings, and limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and retained earnings; and
- * requires that all such transactions be on terms that are consistent with safe and sound banking practices.

The term "covered transaction" includes the making of loans, purchase of assets, issuance of guarantees and other similar types of transactions. Further, most loans by a bank to any of its affiliates must be secured by collateral in amounts ranging from 100 to 130 percent of the loan amounts. In addition, any covered transaction by a bank with an affiliate and any purchase of assets or services by a bank from an affiliate must be on terms that are substantially the same, or at least as favorable to the Bank, as those that would be provided to a non-affiliate.

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Effective April 1, 2003, the Federal Reserve Board, or FRB, rescinded its interpretations of Sections 23A and 23B of the FRA and replaced these interpretations with Regulation W. In addition, Regulation W makes various changes to existing

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law regarding Sections 23A and 23B, including expanding the definition of what constitutes an affiliate subject to Sections 23A and 23B and exempting certain subsidiaries of state-chartered banks from the restrictions of Sections 23A and 23B. We do not expect that the changes made by Regulation W will have a material adverse effect on our business.

The Bank's authority to extend credit to its directors, executive officers and 10% shareholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the FRA and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (a) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features and (b) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank's capital. The regulations allow small discounts on fees on residential mortgages for directors, officers and employees. In addition, extensions for credit in excess of certain limits must be approved by the Bank's Board of Directors.

Section 402 of the Sarbanes-Oxley Act of 2002 prohibits the extension of personal loans to directors and executive officers of issuers (as defined in Sarbanes-Oxley). The prohibition, however, does not apply to mortgages advanced by an insured depository institution, such as the Bank, that are subject to the insider lending restrictions of Section 22(h) of the Federal Reserve Act.

Community Reinvestment Act

Under the Community Reinvestment Act ("CRA"), any insured depository institution, including the Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. The CRA requires the FDIC, in connection with its examination of a commercial bank and trust company, to assess the depository institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such institution, including applications for additional branches and acquisitions.

The CRA requires the FDIC to provide a written evaluation of an institution's CRA performance utilizing a four-tiered descriptive rating system and requires public disclosure of an institution's CRA rating. The Bank received a "Satisfactory" rating on its last CRA exam on July 18, 2005.

Safety and Soundness Standards

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Pursuant to the requirements of the FDICIA, as amended by the Riegle Community Development and Regulatory Improvement Act of 1994, each federal banking agency, including the FDIC, has adopted guidelines establishing general standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, asset quality, earnings and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal stockholder.

In addition, the FDIC adopted regulations to require a bank that is given notice by the FDIC that it is not satisfying any of such safety and soundness standards to submit a compliance plan to the FDIC. If, after being so notified, a bank fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted compliance plan, the FDIC may issue an order directing corrective and other actions of the types to which a significantly undercapitalized institution is subject under the "prompt corrective action" provisions of the FDICIA. If a bank fails to comply with such an order, the FDIC may seek to enforce such an order in judicial proceedings and to impose civil monetary penalties.

Prompt Corrective Action

The FDICIA also established a system of prompt corrective action to resolve the problems of undercapitalized institutions. The FDIC, as well as the other federal banking regulators, adopted regulations governing the supervisory

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actions that may be taken against undercapitalized institutions. The regulations establish five categories, consisting of "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The severity of the action authorized or required to be taken under the prompt corrective action regulations increases as a bank's capital decreases within the three undercapitalized categories. All banks are prohibited from paying dividends or other capital distributions or paying management fees to any controlling person if, following such distribution, the Bank would be undercapitalized.

FEDERAL RESERVE SYSTEM

Under Federal Reserve Board regulations, the Bank is required to maintain noninterest-earning reserves against its transaction accounts. Current Federal Reserve Board regulations generally require that reserves of 3% must be maintained against aggregate transaction accounts of \$47.6 million or less, subject to adjustment by the Federal Reserve Board. Total transaction accounts in excess of \$47.6 million are required to have a reserve of 10% held against them, which are also subject to adjustment by the Federal Reserve Board. The first \$7.0 million of otherwise reservable balances, subject to adjustments by the Federal Reserve Board, are exempted from the reserve requirements. The Bank is in compliance with these requirements. Because required reserves must be maintained in the form of vault cash, a noninterest-bearing account at a Federal Reserve Bank or a pass-through account as defined by the Federal Reserve Board, the effect of this reserve requirement is to reduce the Bank's interest-earning assets.

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FEDERAL HOME LOAN BANK SYSTEM

The Bank is a member of the Federal Home Loan Bank system, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank provides a central credit facility primarily for member institutions. The Bank, as a member of the Federal Home Loan Bank of Boston (the "FHLB"), is required to acquire and hold shares of capital stock in the FHLB in an amount equal to at least 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its advances (borrowings) from the FHLB, whichever is greater. The Bank was in compliance with this requirement with an investment in FHLB stock at December 31, 2005 of \$6.3 million. The Federal Home Loan Banks are required to provide funds for certain purposes including contributing funds for affordable housing programs. These requirements could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members.

THE U.S.A. PATRIOT ACT

The Bank is subject to the USA PATRIOT Act, which gives the federal government new powers to address money laundering and terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and amendments to the Bank Secrecy Act. Title III of the USA PATRIOT Act takes measures intended to encourage information sharing among financial institutions, bank regulatory agencies and law enforcement bodies. Further, certain provisions of Title III impose affirmative obligations on a broad range of financial institutions, including banks, thrifts, brokers, dealers, credit unions, money transfer agents, and parties registered under the Commodity Exchange Act.

Among other requirements, Title III of the USA PATRIOT Act imposes the following obligations on financial institutions:

- * Pursuant to Section 352, all financial institutions must establish anti-money laundering programs that include, at minimum: (i) internal policies, procedures, and controls; (ii) specific designation of an anti-money laundering compliance officer; (iii) ongoing employee training programs; and (iv) an independent audit function to test the anti-money laundering program.
- * Pursuant to Section 326, rules establishing minimum standards for customer due diligence, identification and verification became effective on October 1, 2003.

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- * Section 312 requires financial institutions that establish, maintain, administer, or manage private banking accounts or correspondent accounts in the United States for non-United States persons or their representatives (including foreign individuals visiting the United States) to establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures, and controls designed to detect and report instances of money laundering through those accounts.
- * Section 318, which became effective December 25, 2001, prohibits financial institutions from establishing, maintaining,

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administering, or managing correspondent accounts for foreign shell banks (foreign banks that do not have a physical presence in any country), and requires financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks.

- * Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications.

THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and protect investors from corporate wrongdoing. The Sarbanes-Oxley Act's principal legislation and derivative regulation and rulemaking promulgated by the SEC includes:

- * the creation of an independent accounting oversight board;
- * auditor independence provisions which restrict non-audit services that accountants may provide to their audit clients;
- * additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer certify financial statements;
- * a requirement that companies establish and maintain a system of internal control over financial reporting and that management provide an annual report regarding its assessment of the effectiveness of such internal control over financial reporting to its independent accountants and that such accountants provide an attestation report with respect to management's assessment of the effectiveness of the company's internal control over financial reporting.
- * the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- * an increase in the oversight of, and enhancement of, certain requirements relating to audit committees of public companies and how they interact with the Company's independent auditors;
- * requirement that audit committee members must be independent and are absolutely barred from accepting consulting, advisory or other compensatory fees from the issuer;
- * requirement that companies disclose whether at least one member of the committee is an "audit committee financial expert" (as such term is defined by the Securities and Exchange Commission) and if not, why not;
- * expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods;

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- * a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions;
- * disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code;
- * mandatory disclosure by analysts of potential conflicts of interest; and
- * a range of enhanced penalties for fraud and other violations.

Although the Company has and will continue to incur additional expense in complying with the provisions of the Sarbanes-Oxley Act and the resulting regulations, such compliance will not have a material impact on its results of operations or financial condition.

FEDERAL SECURITIES LAW

The Company's common stock is registered with the SEC under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Thus, the Company is subject to information, proxy solicitation, insider trading restrictions, and other requirements under the Exchange Act.

RECENT REGULATORY EXAMINATIONS

As the result of a 2004 joint examination, on March 14, 2005, the Bank entered into an informal agreement with the FDIC and Massachusetts Commissioner of Banks under which the Bank agreed to certain recommendations designed to strengthen its policies and procedures for compliance with certain provisions of the Bank Secrecy Act.

The FDIC, with concurrence from the Massachusetts Commissioner of Banks, terminated the aforementioned agreement in January 2006.

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ITEM 1A

RISK FACTORS

Our loan portfolio includes loans with a higher risk of loss. We originate multi-family and commercial real estate loans, commercial business loans, consumer loans, and residential mortgage loans primarily within our market area. Commercial mortgage, commercial business, and consumer loans may expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, commercial real estate and commercial business loans may also involve relatively large loan balances to individual borrowers or groups of borrowers. These loans also have greater credit risk than residential real estate for the following reasons:

- * Commercial Real Estate Loans. Repayment is dependent upon income being generated in amounts sufficient to cover operating expenses and debt service. Commercial mortgage loans represented 51.6% of total gross loans as of December 31, 2005.
- * Commercial Loans. Repayment is generally dependent upon the

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successful operation of the borrower's business. Commercial loans represented 9.2% of total gross loans as of December 31, 2005.

- * Construction Loans. Construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction compared to the estimated cost (including interest) of construction and other assumptions, including the estimated time to sell residential properties. Construction loans represented 5.2% of total gross loans as of December 31, 2005.
- * Consumer Loans. Consumer loans (such as personal lines of credit) may or may not be collateralized with assets that provide an adequate source of payment of the loan due to depreciation, damage, or loss. Consumer loans represented 0.6% of total gross loans as of December 31, 2005.

Any downturn in the real estate market or local economy could adversely affect the value of the properties securing the loans or revenues from the borrower's business thereby increasing the risk of non-performing loans.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease. Our loan customers may not repay their loans according to their terms and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. We therefore may experience significant loan losses, which could have a material adverse effect on our operating results.

Material additions to our allowance for loan losses also would materially decrease our net income, and the charge-off of loans may cause us to increase the allowance. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We rely on our loan quality reviews, our historical loss experience and our evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. As of December 31, 2005, the allowance for loan loss as a percent of year-end loans was 1.05%.

Changes in interest rates could adversely affect our results of operations and financial condition. Our profitability, like that of most financial institutions, depends substantially on our net interest income, which is the difference between the interest income earned on our interest-earning assets and the interest expense paid on our interest-bearing liabilities. Increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans. In addition, as market interest rates rise, we will have competitive pressures to increase the rates we pay on deposits, which will result in a decrease of our net interest income.

We also are subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in increased prepayments of

loans and mortgage-related securities as borrowers refinance to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk to the extent that we are unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities.

Our earnings may be adversely impacted by an increase in interest rates because a significant portion of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not reprice as long-term interest rates increase while a majority of our interest-bearing liabilities are expected to reprice as interest rates increase. Therefore, in an increasing interest rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan portfolio and securities portfolio. An increasing rate environment is expected to cause a narrowing of our net interest rate spread and a decrease in our net interest income. The rising interest rate environment has compressed our net interest margin from 3.44% for the year ended December 31, 2004 to 3.39% for the year ended December 31, 2005.

Our local economy may affect our future growth possibilities. Our current market area is principally located in southeastern Massachusetts and contiguous areas of Rhode Island. Our future growth opportunities depend on the growth and stability of our regional economy and our ability to expand our market area. A downturn in our local economy may limit funds available for deposit and may negatively affect our borrowers' ability to repay their loans on a timely basis, both of which could have an impact on our profitability.

Competition in our primary market area may reduce our ability to attract and retain deposits and originate loans. We operate in a competitive market for both attracting deposits, which is our primary source of funds, and originating loans. Historically, our most direct competition for savings deposits has come from credit unions, community banks, large commercial banks and thrift institutions in our primary market area. Particularly in times of extremely low or extremely high interest rates, we have faced additional significant competition for investors' funds from brokerage firms and other firms' short-term money market securities and corporate and government securities. Our competition for loans comes principally from mortgage brokers, commercial banks, other thrift institutions, and insurance companies. Competition for loan originations and deposits may limit our future growth and earnings prospects.

We operate in a highly regulated environment, and changes in laws and regulations to which we are subject may adversely affect our results of operations. We are subject to extensive regulation, supervision and examination by the state of Massachusetts, as the Bank's chartering authority, and by the Federal Deposit Insurance Corporation (the "FDIC") as the insurer of our deposits up to certain limits. We also belong to the Federal Home Loan Bank System and, as a member of such system, we are subject to certain limited regulations promulgated by the Federal Home Loan Bank of Boston. This regulation and supervision limits the activities in which we may engage. The purpose of regulation and supervision is primarily to protect our depositors and borrowers and, in the case of FDIC regulation, the FDIC's insurance fund. Regulatory authorities have extensive discretion in the exercise of their supervisory and enforcement powers. They may, among other things, impose restrictions on the operation of a banking institution, the classification of assets by such institution and such institution's allowance for loan losses. Regulatory and law enforcement authorities also have wide discretion and extensive enforcement powers under various consumer

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protection and civil rights laws, including the Truth-in-Lending Act, the Equal Credit Opportunity Act, the Fair Housing Act, and the Real Estate Settlement Procedures Act. Any change in the laws or regulations applicable to us, or in banking regulators' supervisory policies or examination procedures, whether by the Massachusetts Commissioner of Banks, the FDIC, other state or federal regulators, the United States Congress or the Massachusetts legislature could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We depend on our executive officers and key personnel to continue the implementation of our long-term business strategy and could be harmed by the loss of their services. We believe that our continued growth and future success will depend in large part upon the skills of our management team. The competition for qualified personnel in the financial services industry is intense, and the loss of our key personnel or an inability to continue to attract, retain and motivate key personnel could adversely affect our business. We cannot assure you that we will be able to retain our existing key personnel or attract additional qualified personnel. Although we have employment agreements with our president and chief executive officer, our executive vice president and chief financial officer/chief operations officer, and our senior vice president that contain non-compete provisions, the loss of the services of one or more of our executive officers and key personnel could impair our ability to continue to develop our business strategy.

If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, and, as a result, investors and depositors could lose confidence in our financial reporting, which could adversely affect our business, the trading price of our stock and our ability to attract additional deposits. In the future, we will be required to include in our annual reports filed with the Securities and

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Exchange Commission (the "SEC") a report of our management regarding internal control over financial reporting beginning with our annual report for the fiscal year ended December 31, 2007. We expect this requirement to be in effect beginning with our annual report for the fiscal year ended December 31, 2007. However, if we become an "accelerated filer," as defined by SEC regulations, we will have to comply with this requirement beginning with our annual report for the fiscal year ended December 31, 2006. In anticipation of this new obligation, we have begun to document and evaluate our internal control over financial reporting in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and SEC rules and regulations, which require an annual management report on our internal control over financial reporting, including, among other matters, management's assessment of the effectiveness of internal control over financial reporting and an attestation report by our independent auditors addressing these assessments. Accordingly, management has retained outside consultants to assist us in (i) assessing and documenting the adequacy of our internal control over financial reporting, (ii) improving control processes, where appropriate, and (iii) verifying through testing that controls are functioning as documented. If we fail to identify and correct any significant deficiencies in the design or operating effectiveness of our internal control over financial reporting or fail to prevent fraud, current and potential stockholders and depositors could lose confidence in our financial reporting, which could adversely affect our business, financial condition and results of operations, the trading price of our stock and our ability to attract additional deposits.

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ITEM 1B

UNRESOLVED STAFF COMMENTS

There were no unresolved staff comments as of December 31, 2005.

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ITEM 2

PROPERTIES

Our main office is located at 100 Slade's Ferry Avenue, Somerset, Massachusetts at the junctions of U.S. Routes 6, 138, and 103. We operate our business from ten office locations in Assonet, Fairhaven, Fall River, New Bedford, Seekonk, Somerset and Swansea, Massachusetts. As of December 31, 2005, the following properties were owned through the Bank's wholly-owned subsidiary, Slade's Ferry Realty Trust:

| | Location ----- | | Sq. Footage ----- |
|------------------|--------------------------|-----------------|----------------------|
| Main Office | 100 Slade's Ferry Avenue | Somerset, MA | 42,000 |
| North Somerset | 2722 County Street | Somerset, MA | 3,025 |
| Linden Street | 244-253 Linden Street | Fall River, MA | 1,750 |
| Brayton Avenue | 855 Brayton Avenue | Fall River, MA | 3,325 |
| North Swansea | 2388 G.A.R. Highway | Swansea, MA | 2,960 |
| Seekonk | 1400 Fall River Avenue | Seekonk, MA | 2,300 |
| Fairhaven | 75 Huttleston Avenue | Fairhaven, MA | 13,000 |
| Ashley Boulevard | 833 Ashley Boulevard | New Bedford, MA | 2,655 |

The office listed below is leased by the Bank with the indicated lease expiration date.

| | | | |
|----------------------------------------------------------------------------------------|-----------------------|-------------|-------|
| Assonet | 58B South Main Street | Assonet, MA | 2,000 |
| (expires February 2010 with two options to extend term of lease for five year periods) | | | |

The facility listed below is owned by the Bank, however, the land is leased with the indicated lease expiration date.

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Brayton Avenue
Drive-Up Complex 16 Stevens Street Fall River, MA 549
(expires October 2015)

The main office building contains approximately 42,000 square feet of usable space which we occupy. We also operate a school banking facility located in the Somerset High School, Grandview Avenue, Somerset, Massachusetts that consists of 200 square feet. This facility provides basic banking services to students and school staff. The Seekonk office is an 8,800 square foot building of which we utilize 2,300 square feet and lease out the remainder.

We own an ATM dispenser, located at 58A South Main Street, Assonet, Massachusetts. We sublease the space on which the ATM dispenser is located. The original term of lease expires October 2009.

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ITEM 3

LEGAL PROCEEDINGS

We are not involved in any pending legal proceedings that would have a material impact on our consolidated financial condition and results of operations.

ITEM 4

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of 2005, no matters were submitted to a vote of our stockholders.

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PART II

ITEM 5

MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is listed in the Nasdaq Capital Market under the symbol SFBC. The following table sets forth the range of high and low bid price for our common stock as reported for the Nasdaq Capital Market by quarter for the two-year period ended:

| December 31, | | | |
|--------------|-----------|------------|-----------|
| 2005 | | 2004 | |
| High Price | Low Price | High Price | Low Price |

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| First Quarter | \$20.80 | \$18.01 | \$24.00 | \$21.75 |
|----------------|---------|---------|---------|---------|
| Second Quarter | \$19.00 | \$18.01 | \$22.00 | \$17.35 |
| Third Quarter | \$20.25 | \$17.75 | \$22.94 | \$18.65 |
| Fourth Quarter | \$21.68 | \$18.00 | \$20.90 | \$19.01 |

During 2005, there were no shares repurchased.

Holders

As of March 17, 2006, there were 1,275 holders of an aggregate of 4,156,712 shares of common stock issued and outstanding.

Dividends - History and Policy

Slade's Ferry Bancorp., since its inception in 1990 and prior thereto the Bank, has consistently paid dividends to shareholders since 1961. We paid four quarterly cash dividends of \$.09 per share for a total of \$.36 per share during each of 2004 and 2005.

The declaration of cash dividends is dependent on a number of factors, including regulatory limitations, and the Bank's operating results and financial condition. Our shareholders will be entitled to dividends only when, and if, declared by the Board of Directors out of funds legally available. Under the Massachusetts Business Company Law, a dividend may not be declared if the Company is insolvent or if the declaration of the dividend would render the Company insolvent.

Chapter 172 Section 28 of the Massachusetts Statutes on Banks and Banking provides that a bank's Board of Directors may, subject to the restriction contained in the section, declare and pay dividends on capital stock out of net profits from time to time and to such extent as they deem advisable. However, under this provision, no cash dividend shall be paid unless, following the payment of such dividend, the capital stock and retained earnings account will be unimpaired.

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Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth information pertaining to our equity compensation plans in effect as of December 31, 2005.

Equity Compensation Plan Information

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding amounts reflected in column (a)) |
|---------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|
| | (a) | (b) | (c) |
| ----- | ----- | ----- | ----- |

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| | | | |
|------------------------------------------------------------|----------------|----------------|----------------|
| Equity compensation plans approved by security holders | 254,945 | \$17.35 | 152,394 |
| Equity compensation plans not approved by security holders | - | - | - |
| Total | 254,945 | \$17.35 | 152,394 |

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ITEM 6

SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth selected financial data for the last five years from the consolidated financial statements of Slade's Ferry Bancorp. The following information is only a summary and should be read in conjunction with our consolidated financial statements and notes.

| | At or for the Years Ended Dec | | |
|------------------------------------|-----------------------------------|------------|------------|
| | 2005 | 2004 | 2003 |
| | (Dollars in thousands, except per | | |
| EARNINGS DATA | | | |
| Interest and dividend income | \$ 28,919 | \$ 24,106 | \$ 20,617 |
| Interest expense | 10,995 | 7,946 | 6,073 |
| Net interest income | 17,924 | 16,160 | 14,544 |
| Provision (credit) for loan losses | 167 | 376 | (602) |
| Noninterest income | 2,320 | 2,505 | 2,214 |
| Noninterest expense | 13,896 | 12,785 | 12,669 |
| Income before income taxes | 6,181 | 5,504 | 4,691 |
| Provision for income taxes | 2,161 | 1,887 | 2,007 |
| Net income | 4,020 | 3,617 | 2,684 |
| Return on average assets | 0.70% | 0.70% | 0.64% |
| Return on average equity | 8.36% | 8.28% | 6.47% |
| Net interest margin | 3.39% | 3.44% | 3.91% |
| Net interest spread | 2.96% | 3.07% | 3.48% |
| Basic earnings per share | \$ 0.98 | \$ 0.89 | \$ 0.68 |
| Diluted earnings per share | \$ 0.97 | \$ 0.88 | \$ 0.67 |
| Cash dividends declared per share | \$ 0.36 | \$ 0.36 | \$ 0.36 |
| Dividend payout ratio | 36.84% | 40.31% | 53.32% |
| BALANCE SHEET DATA | | | |
| Assets | \$ 585,914 | \$ 549,398 | \$ 439,234 |
| Loans, net of deferred loan fees | 413,943 | 366,366 | 335,651 |
| Allowance for loan losses | 4,333 | 4,101 | 4,154 |
| Loans, net | 409,610 | 362,265 | 331,497 |

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| | | | |
|--------------------------------------------------|-----------|-----------|-----------|
| Goodwill | 2,173 | 2,173 | 2,173 |
| Securities and FHLB Stock | 129,908 | 126,305 | 61,487 |
| Deposits | 415,846 | 399,905 | 333,145 |
| Borrowings | 118,175 | 100,596 | 60,475 |
| Stockholders' equity | 48,855 | 46,601 | 42,537 |
| Average equity as a percentage of average assets | 8.40% | 8.49% | 9.97% |
| Shares outstanding at end of period | 4,132,200 | 4,068,423 | 3,995,857 |
| Book value per share at end of period | \$ 11.82 | \$ 11.45 | \$ 10.65 |

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ITEM 7

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of Management's Discussion and Analysis is to focus on certain significant factors which have affected our operating results and financial condition, and to provide shareholders a more comprehensive review of the financial data contained in this report. The following discussion should be read in conjunction with our audited financial statements and notes thereto, included as pages F-1 through F-42 of this report.

2005 ITEMS OF SIGNIFICANCE

- * In 2005, we recorded net income of \$4.0 million or \$0.97 per share on a diluted basis compared to \$3.6 million or \$0.88 per share on a diluted basis in 2004. This represents an increase of \$403,000 or 11.1% in net income and \$0.09 or 10.2% per share on a diluted basis between 2005 and 2004. This increase is due to an increase in net interest income of \$1.8 million arising from our growth. Our return on average equity for the year ended December 31, 2005 was 8.36%, as compared to 8.28% for the year ended December 31, 2004.
- * 2005 experienced a rising rate environment with prime interest rate increasing 200 basis points, combined with intense competition for deposits in our market area. As a result, our net interest margin has compressed from 3.44% for the year ended December 31, 2004 to 3.39% for the year ended December 31, 2005.
- * The book value of our common stock increased from \$11.45 per share at December 31, 2004 to \$11.82 at December 31, 2005.
- * Total assets increased by \$36.5 million, or 6.6% from the fiscal year ended December 31, 2004.
- * Total gross loans increased by \$47.5 million, or 12.9% from the fiscal year ended December 31, 2004.
- * Capital adequacy ratios continue to meet the criteria of "well capitalized" under regulatory guidelines.
- * As we remain committed to customer service, our technology improvement plan calls for the continued upgrading of the systems utilized on the teller platform and in customer service areas to allow employees to serve customers more efficiently.

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- * In April 2005, we opened our newest facility, located in Assonet, Massachusetts. This branch is a state-of-the-art full-service banking office, designed to provide superior customer convenience and service.

FINANCIAL CONDITION

Total assets increased by \$36.5 million, or 6.6%, from \$549.4 million at December 31, 2004 to \$585.9 million at December 31, 2005. The increase in total assets during 2005 is the result of planned growth across the balance sheet. Total net loans increased from \$362.3 million at December 31, 2004 to \$409.6 million, an increase of \$47.3 million or 13.1%, while the investment portfolio increased from \$126.3 million at December 31, 2004 to \$129.9 million at December 31, 2005, an increase of 2.9%. The combination of growth in deposits and FHLB advances funded the increase in loans and investments. Total deposits increased from \$399.9 million at December 31, 2004 to \$415.8 million at December 31, 2005, an increase of \$15.9 million or 4.0%. Total FHLB advances increased by \$17.6 million or 19.5%, to \$107.9 million at December 31, 2005 from \$90.3 million at December 31, 2004.

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INVESTMENT PORTFOLIO

The main objectives of our investment portfolio are to achieve a competitive rate of return over a reasonable time period and to provide liquidity.

Our total investment portfolio increased from \$126.3 million at December 31, 2004 to \$129.9 million at December 31, 2005, an increase of 2.9%. The increase is the result of the investment of excess funds from both deposits and borrowings into obligations of government-sponsored entities and mortgage-backed securities, which were raised in accordance with our strategic plans. Certain mortgage-backed securities totaling \$28.0 million were purchased during 2005 as a direct replacement of loans, as loan pay-offs exceeded management's expectations.

The current investment strategy has concentrated on the purchase of state and municipal obligations generally maturing or callable within five to seven years. The investment policy also permits investments in mortgage-backed securities, usually having a longer weighted average life. The investment policy, however, limits the duration of the aggregate investment portfolio to 5 years. At December 31, 2005, the portfolio duration was 2.8 years. We do not purchase investments with imbedded derivative characteristics, or free-standing derivative instruments such as swaps, options, or futures.

Securities Held to Maturity

The held-to-maturity portfolio consists of mortgage-backed securities and securities issued by states and municipalities. Held-to-maturity securities decreased from \$37.8 million at December 31, 2004 to \$29.3 million at December 31, 2005. The decrease is the result of the maturity, calls and paydowns of certain state and municipal obligations and mortgage-backed securities. Those funds were used to increase the available for sale portfolio to provide liquidity for future loan growth. Management has designated these mortgage-backed securities to secure advances from the FHLB. We have the positive intent and ability to hold these securities to maturity.

The following table shows the amortized cost basis and fair value of the

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major categories of investment securities held to maturity for the years indicated:

| | December 31, | | | |
|-----------------------------------|-------------------------|------------|-------------------------|------------|
| | 2005 | | 2004 | |
| | Amortized Cost Basis | Fair Value | Amortized Cost Basis | Fair Value |
| | (In thousands) | | | |
| State and municipal obligations | \$ 6,766 | \$ 6,892 | \$ 8,588 | \$ 8,928 |
| Mortgage-backed securities | 22,540 | 21,966 | 29,185 | 29,184 |
| Total securities held to maturity | \$29,306 | \$28,858 | \$37,773 | \$38,112 |

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The following table shows the amortized cost basis of securities held to maturity with the weighted average interest yield for each maturity range.

| | December 31, 2005 | | |
|-------------------------------|----------------------------------------|-----------------------------------|----------|
| | State and Municipal Obligations (2) | Mortgage-Backed Securities (1) | Total |
| | (Dollars in thousands) | | |
| Maturity | | | |
| ----- | | | |
| Within 1 year | \$1,761 | \$ - | \$ 1,761 |
| Yield | 6.04% | 0.00% | 6.04% |
| After 1 year through 5 years | 2,793 | - | 2,793 |
| Yield | 5.86% | 0.00% | 5.86% |
| After 5 year through 10 years | 1,014 | - | 1,014 |
| Yield | 6.48% | 0.00% | 6.48% |
| Over 10 years | 1,198 | 22,540 | 23,738 |
| Yield | 6.90% | 5.42% | 5.49% |
| Amount | \$6,766 | \$22,540 | \$29,306 |
| Yield | 6.18% | 5.42% | 5.60% |