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Selected Consolidated Financial Data

(in \$1,000s, except per share data)

	As of and for the Year Ended December 31				
	2004 ⁽¹⁾	2003 ⁽²⁾	2002 ⁽³⁾	2001 ⁽⁴⁾	2000 ⁽⁵⁾
For the year:					
Interest income	\$ 179,089	\$ 164,416	\$ 156,454	\$ 153,797	\$ 132,311
Interest expense	47,496	49,490	55,860	73,292	65,912
Net interest income	131,593	114,926	100,594	80,505	66,399
Provision for loan losses	12,708	9,861	12,676	8,167	7,216
Noninterest income	19,252	20,087	14,982	9,585	6,137
Noninterest expense	97,787	86,952	76,538	63,944	52,410
Net income	26,716	23,380	16,653	10,718	8,035
Net income per share:					
Basic	1.88	1.86	1.64	1.38	1.14
Diluted	1.79	1.77	1.57	1.35	1.13
Cash dividends paid per share	.65	.51	.44	.40	.36
At end of year:					
Total assets	\$3,091,418	\$2,737,062	\$2,409,288	\$2,044,006	\$1,630,076
Total earning assets	2,885,545	2,521,375	2,226,969	1,920,621	1,517,350
Portfolio loans	2,692,904	2,247,440	1,991,372	1,734,589	1,355,798
Deposits	2,510,072	2,288,664	2,062,072	1,740,385	1,400,899
Notes payable	172,534	92,774	93,398	89,911	58,150
Subordinated debentures	100,845	90,816	51,583	48,621	24,327
Minority interests in consolidated subsidiaries	39,520	30,946	28,016	70,673	62,575
Stockholders' equity	252,159	218,897	160,037	80,172	70,404

	Quarterly Results of Operations (unaudited)				
	Total for the Year	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Year ended December 31, 2004: ⁽¹⁾					
Interest income	\$ 179,089	\$ 48,329	\$ 45,877	\$ 43,434	\$ 41,449
Interest expense	47,496	12,848	11,943	11,486	11,219
Net interest income	131,593	35,481	33,934	31,948	30,230
Provision for loan losses	12,708	3,111	3,553	2,536	3,508
Net income	26,716	7,950	7,439	6,911	4,416
Net income per share:					
Basic	1.88	.55	.52	.49	.32
Diluted	1.79	.52	.50	.47	.30
Cash dividends paid per share	.65	.17	.17	.16	.15
Year ended December 31, 2003: ⁽²⁾					
Interest income	\$ 164,416	\$ 41,859	\$ 41,484	\$ 41,087	\$ 39,986
Interest expense	49,490	11,305	12,065	13,121	12,999
Net interest income	114,926	30,554	29,419	27,966	26,987
Provision for loan losses	9,861	3,253	2,892	1,826	1,890
Net income	23,380	6,324	6,049	5,694	5,313
Net income per share:					
Basic	1.86	.47	.46	.46	.45
Diluted	1.77	.45	.44	.45	.44
Cash dividends paid per share	.51	.15	.12	.12	.12

(1) Includes First Carolina State Bank (located in Rocky Mount, North Carolina), acquired April 1, 2004 and Point Loma Community Bank (located in San Diego, California), effective August 2, 2004.

(2) Includes Bank of Escondido (located in Escondido, California), effective October 2003.

(3) Includes Bank of Las Vegas (located in Las Vegas, Nevada), effective February 2002 and Napa Community Bank (located in Napa, California), effective March 2002.

(4) Includes Sunrise Bank of San Diego (located in San Diego, California), effective January 2001.

(5) Includes Black Mountain Community Bank effective March 2000 (located in Henderson, Nevada), Sunrise Bank of Albuquerque effective April 2000 (located in Albuquerque, New Mexico), Arrowhead Community Bank effective September 2000 (located in Glendale, Arizona), Goshen Community Bank effective September 2000 (located in Goshen, Indiana) and Yuma Community Bank effective December 2000 (located in Yuma, Arizona).

INFORMATION REGARDING CAPITOL'S COMMON STOCK

On June 24, 2003, Capitol's common stock began trading on the New York Stock Exchange (NYSE) under the symbol "CBC". Capitol's common stock was previously traded on the National Market System of The Nasdaq Stock MarketSM under the symbol "CBCL". Market quotations regarding the range of high and low sales prices of Capitol's common stock, which reflect inter-dealer prices without retail mark-up, mark-down or commissions, were as follows:

Quarter Ended:	2004		2003	
	Low	High	Low	High
March 31	\$26.47	\$29.70	\$19.00	\$24.25
June 30	24.05	28.00	20.00	27.88
September 30	24.15	29.80	23.10	28.49
December 31	28.51	36.00	25.72	30.10

During 2004, Capitol paid cash dividends of \$0.15 per share in the first quarter, \$0.16 per share in the second quarter and \$0.17 per share in the third and fourth quarters. In 2003, Capitol paid cash dividends of \$0.12 per share in the first, second and third quarters and \$0.15 per share in the fourth quarter.

As of January 31, 2005, there were 7,561 beneficial holders of Capitol's common stock, based on information supplied to Capitol from its stock transfer agent and other sources.

At February 28, 2005, 14,888,400 shares of common stock were outstanding. Capitol's stock transfer agent is UMB Bank, n.a., 928 Grand Ave., P.O. Box 410064, Kansas City, Missouri 64141-0064 (telephone 800/884-4225). The web site for UMB Bank, n.a. is <http://www.umb.com>.

Capitol has a direct purchase and dividend reinvestment plan, the Capitol Bancorp Limited Direct Purchase and Dividend Reinvestment Plan, "Capitol Bancorp Direct", which offers a variety of convenient features including dividend reinvestment, certain fee-free transactions, certificate safekeeping and other benefits. For a copy of the Plan prospectus, informational brochure and enrollment materials, contact UMB Bank, n.a. at 800/884-4225 or Capitol at 517/487-6555.

In addition to Capitol's common stock, trust-preferred securities of Capitol Trust I (a subsidiary of Capitol) are listed on NYSE under the symbol "CBCPrA". Those trust-preferred securities consist of 2,530,000, 8.5% cumulative preferred securities, with a liquidation amount of \$10 per preferred security. The trust-preferred securities are guaranteed by Capitol and mature in 2027, are currently callable and may be extended to 2036 if certain conditions are met.

AVAILABILITY OF FORM 10-K AND CERTAIN OTHER REPORTS

A copy of Capitol's 2004 report on Form 10-K, without exhibits, is available to holders of its common stock or trust-preferred securities without charge, upon written request. Form 10-K includes certain statistical and other information regarding Capitol and its business. Requests to obtain Form 10-K should be addressed to Investor Relations, Capitol Bancorp Limited, Capitol Bancorp Center, 200 Washington Square North, Lansing, Michigan 48933.

Form 10-K and certain other periodic reports are filed with the Securities and Exchange Commission (SEC). The SEC maintains an Internet web site that contains reports, proxy and information statements and other information regarding companies which file electronically (which includes Capitol). The SEC's web site address is <http://www.sec.gov>. Capitol's filings with the SEC are also available at Capitol's web site, <http://www.capitolbancorp.com>.

OTHER CORPORATE INFORMATION

CORPORATE OFFICES

Capitol Bancorp Center
200 Washington Square North
Lansing, Michigan 48933
517/487-6555
www.capitolbancorp.com

2777 East Camelback Road
Suite 375
Phoenix, Arizona 85016
602/955-6100
www.capitolbancorp.com

INDEPENDENT AUDITORS

BDO Seidman, LLP
Grand Rapids, Michigan

SHAREHOLDER INFORMATION

ANNUAL MEETING

Capitol's Annual Meeting will be held on Thursday, May 5, 2005 at 4:00 p.m. at the Lansing Center, located at 333 E. Michigan Avenue, Lansing, Michigan.

COMMON STOCK TRADING INFORMATION

Capitol's common stock trades on the New York Stock Exchange (NYSE) under the trading symbol "CBC".

COMMON STOCK TRANSFER AGENT

UMB Bank, n.a.
928 Grand Avenue
P.O. Box 410064
Kansas City, Missouri 64141-0064
800/884-4225

DIRECT PURCHASE AND DIVIDEND REINVESTMENT PLAN

Capitol offers an easy and affordable way to invest in Capitol's common stock through its direct purchase and dividend reinvestment plan, Capitol Bancorp Direct. The Plan's benefits include the ability to make an initial investment in common stock with as little as \$50, reinvestment of dividends in additional common stock, direct deposit of dividends, ability to purchase common stock as frequently as once a month, and the option to make transfers or gifts of Capitol's common stock to another person. Participation in the Plan is voluntary and shareholders and prospective investors are eligible. Purchases under the Plan are not currently subject to any brokerage fees or commissions. For further information regarding Capitol Bancorp Direct or a copy of the Plan's prospectus, informational brochure and enrollment materials, contact UMB Bank, n.a. at 800/884-4225 or Capitol at 517/487-6555.

TRUST-PREFERRED SECURITIES TRADING INFORMATION

Preferred securities of Capitol Trust I (a subsidiary of Capitol) trade on NYSE under the trading symbol “CBCPrA”.

TRUST-PREFERRED SECURITIES TRUSTEE

Bank One Investment Management Group – Chicago, Illinois

CAUTIONS REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements contained in this annual report that are not historical facts are forward-looking statements. Those forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, are subject to known and unknown risks, uncertainties and other factors which may cause the actual future results, performance or achievements of Capitol and/or its subsidiaries and other operating units to differ materially from those contemplated in such forward-looking statements. The words “intend”, “expect”, “project”, “estimate”, “predict”, “anticipate”, “should”, “will”, “may”, “believe” and similar expressions also identify forward-looking statements. Important factors which may cause actual results to differ from those contemplated in such forward-looking statements include, but are not limited to: (i) the results of Capitol’s efforts to implement its business strategy, (ii) changes in interest rates, (iii) legislation or regulatory requirements adversely impacting Capitol’s banking business and/or expansion strategy, (iv) adverse changes in business conditions or inflation, (v) general economic conditions, either nationally or regionally, which are less favorable than expected and that result in, among other things, a deterioration in credit quality and/or loan performance and collectability, (vi) competitive pressures among financial institutions, (vii) changes in securities markets, (viii) actions of competitors of Capitol’s banks and Capitol’s ability to respond to such actions, (ix) the cost of capital, which may depend in part on Capitol’s asset quality, prospects and outlook, (x) changes in governmental regulation, tax rates and similar matters, (xi) changes in management and (xii) other risks detailed in Capitol’s other filings with the Securities and Exchange Commission. If one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect, actual outcomes may vary materially from those indicated. The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make certain estimates and assumptions, many of which are based on assumptions relating to the above-stated forward-looking statements, that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results will differ from those estimates because of the inherent subjectivity and inaccuracy of any estimation. All subsequent written or oral forward-looking statements attributable to Capitol or persons acting on its behalf are expressly qualified in their entirety by the foregoing factors. Investors and other interested parties are cautioned not to place undue reliance on such statements, which speak as of the date of such statements. Capitol undertakes no obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of unanticipated events.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Preface

This section of Capitol's annual report is a narrative which intends to discuss, through the eyes of management, the Corporation's results of operations, financial condition and other important related matters. It is not intended to be a line-by-line review of Capitol's financial statements, but rather a review of certain select matters in the financial statements and the Corporation's business. One critical assumption and expectation is made here, and that is that you, the reader, has read the accompanying consolidated financial statements and footnotes.

This section of the annual report includes the use of some forward-looking statements. The accompanying consolidated financial statements are based on historical information. Forward-looking statements are those which speak to potential future events or outcomes. Those forward-looking statements are believed to be reasonably accurate as of the date this narrative was written but, obviously, future facts and circumstances will change and actual results can differ materially. Readers are cautioned about those forward-looking statements and Capitol has no obligation to update those statements at a later date.

Capitol Bancorp and its Banking Business

Capitol considers itself to be a unique company in the banking business in the United States today. In legal structure, Capitol is a bank-holding company (which means it has banks as subsidiaries). Capitol defines itself as a **bank development** company. What sets Capitol apart from other bank-holding companies is its focus on chartered bank development as a core business in an environment where other bank-holding companies have focused on branch-banking. Big banks focus on transaction volume. Capitol's chartered banks are small and focus on relationships.

At December 31, 2004, Capitol's banking network consisted of 32 separately-chartered community banks, operating in 9 states. All of those banks have different names, typically directly associated with their individual communities. Locally, those banks have a minimally visible identity with Capitol. The banks' individual focus is on their community, their customers, their business and financial performance. Each bank has its own board of directors, comprised of business leaders and other professionals drawn from that bank's community. Together, all of Capitol's banks had nearly 400 independent local board seats at year-end 2004. Each bank has full, local decision-making authority in all matters affecting the customer both in lending and deposit transactions.

Capitol's role with its banks is as investor, mentor and service provider. As investor, Capitol closely monitors the financial performance of its bank subsidiaries, providing assistance and guidance when and where necessary to enhance bank performance. Capitol's mentoring role is most active in its youngest affiliates where guidance is needed through the banks' early formative stages. Capitol provides efficient back-office services to all of its banks, in many areas which can be done centrally and do not involve a direct interface with the bank customer, such as these:

- Accounting
- Data processing
- Human resources administration
- Legal support
- Internal audit
- Risk management
- Credit administration
- Capital management

Some of these functions are performed nationally from a single location, while others are performed regionally, where it is more efficient to have personnel located geographically based on their respective responsibilities in relation to the physical location of the banks.

Capitol has an especially unique approach to the formation of *de novo*, or new, banks. When forming a start-up bank, Capitol, or one of its bank-development subsidiaries, invests at least 51% of the initial capital and the remainder of the capital is raised in the community where the *de novo* bank will be located. This usually involves about 100 or more local investors. When the bank nears its third anniversary of operation, Capitol has typically offered an 'exit opportunity' regarding the shares of the bank not owned by Capitol, to exchange those shares for Capitol's common stock at a premium, usually at about 50% over the book value of the bank stock. When Capitol has made these share exchange proposals, which have been subject to the approval of those minority shareholders, they have been overwhelmingly approved.

Capitol operates from headquarters in Lansing, Michigan (the location of its first bank) and Phoenix, Arizona. It has executive personnel at both locations. These locations help facilitate Capitol's regional managerial focus whereby the Phoenix headquarters' staff includes bank performance personnel responsible for oversight of Capitol's banks in the Western Regions, which at December 31, 2004 included the Southwestern Region (states of Arizona, Nevada and New Mexico) and the California Region. The Lansing headquarters' staff includes bank performance personnel responsible for oversight of the Great Lakes Region (states of Michigan and Indiana) and Southeastern Region (state of North Carolina).

The total assets and revenues of each bank and the consolidated totals are summarized below as of and for the year ended December 31, 2004 and 2003 (in \$1,000s):

	Total Assets		Total Revenues	
	2004	2003	2004	2003
<i>Eastern Regions:</i>				
Great Lakes Region:				
Ann Arbor Commerce Bank	\$ 330,488	\$ 329,191	\$ 21,663	\$ 22,722
Brighton Commerce Bank	105,890	92,184	6,259	5,767
Capitol National Bank	228,656	221,426	13,861	13,220
Detroit Commerce Bank	70,036	44,954	4,030	2,329
Elkhart Community Bank	67,099	53,586	3,996	3,168
Goshen Community Bank	54,571	46,751	3,218	2,943
Grand Haven Bank	119,254	122,076	6,974	9,346
Kent Commerce Bank	89,393	81,437	5,439	5,439
Macomb Community Bank	94,847	86,001	5,786	5,702
Muskegon Commerce Bank	94,162	85,908	6,301	6,255
Oakland Commerce Bank	130,779	120,059	7,731	7,848
Paragon Bank & Trust	110,128	104,602	7,105	8,238
Portage Commerce Bank	180,817	161,028	11,703	10,599
Great Lakes Region Total	1,676,120	1,549,203	104,066	103,576
First Carolina State Bank ⁽¹⁾	68,598		2,455	
<i>Western Regions:</i>				
Southwest Region:				
Arrowhead Community Bank	70,989	56,192	5,180	4,135
Bank of Las Vegas	47,538	35,374	2,963	2,005
Bank of Tucson	168,469	157,717	10,250	9,582
Black Mountain Community Bank	100,415	83,760	6,232	4,849
Camelback Community Bank	83,414	81,649	5,548	5,736
Desert Community Bank	63,276	61,537	4,218	3,761
East Valley Community Bank	46,549	43,925	3,261	2,868
Mesa Bank	96,158	70,308	7,025	5,549
Red Rock Community Bank	102,832	104,944	6,017	6,817
Southern Arizona Community Bank	83,140	84,374	5,507	5,370
Sunrise Bank of Albuquerque	69,055	66,359	5,182	4,511
Sunrise Bank of Arizona	128,192	126,114	11,676	10,605
Valley First Community Bank	54,857	47,069	3,263	3,032
Yuma Community Bank	59,355	46,143	4,015	3,297
Southwest Region Total	1,174,239	1,065,465	80,337	72,117
California Region:				
Bank of Escondido	50,956	26,843	2,054	136
Napa Community Bank	79,396	53,509	4,101	2,808
Point Loma Community Bank ⁽²⁾	20,857		208	
Sunrise Bank of San Diego	62,672	67,235	5,232	4,431
California Region Total	213,881	147,587	11,595	7,375
Other, net	(41,420)	(25,193)	(112)	1,435
Consolidated totals	<u>\$3,091,418</u>	<u>\$2,737,062</u>	<u>\$ 198,341</u>	<u>\$ 184,503</u>

(1) Acquired effective April 1, 2004.

(2) Commenced operations in August 2004 and is 51%-owned by First California Southern Bancorp, a majority-owned subsidiary of Capitol.

In addition to the regions within the Eastern and Western Regions in which Capitol had banks at December 31, 2004, a number of bank-development initiatives were underway at the beginning of 2005 in several other locations which are discussed later in this narrative.

Highlights of 2004

2004 was another record year for Capitol Bancorp. Earnings for the year exceeded \$26.7 million. 2004 earnings surpassed 2003 by 14.3%. Earnings per share in 2004 increased marginally due, in part, to a 13% increase in the diluted share base.

2004 also recorded some very significant changes within the Capitol family:

- An increase in total assets, exceeding \$3 billion for the first time in the Corporation's history.
- Acquisition of First Carolina State Bank in Rocky Mount, North Carolina.
- Opening Capitol's fourth California bank, Point Loma Community Bank.
- Completion of two share-exchange transactions, resulting in two previously majority-owned subsidiaries becoming wholly-owned.
- Increases in the Corporation's quarterly cash dividend to \$.17 per share.
- Expansion of bank-development activities which are anticipated to result in a significant number of new banks during the next several years.

Total consolidated assets approximated \$3.1 billion at December 31, 2004, an increase of about \$354.4 million or 12.9% for the year. Capitol's largest single asset, loans, neared \$2.7 billion. Capitol continued to maintain a strong allowance for loan losses which, at December 31, 2004, approximated 1.40% of portfolio loans. Asset quality improved as nonperforming loans, as a percentage of portfolio loans, decreased compared to year-end 2003. Net loan charge-offs, as a percentage of average loans, also decreased in 2004.

Critical Accounting Policies Affecting Capitol's Financial Statements

Note B of the notes to the consolidated financial statements is captioned *Significant Accounting Policies*. That footnote spans several pages and at least 15 topics, all of which are deemed "significant" and required disclosures under generally accepted accounting principles (GAAP). For purposes of this narrative, current SEC guidance suggests the selection of a few of those, for discussion, as "critical accounting policies". The selection of which few will differ from company to company, even within a common industry, such as banking. Capitol considers its critical accounting policies to include the following:

Use of estimates in determining the allowance for loan losses. Bank regulatory agencies, accounting standard setters and the SEC have all issued commentary, guidance and a variety of rule-making on how financial institutions are to determine the amount of their allowance for loan losses. Determining the allowance is really a process and methodology which is inherently judgmental in how and when to recognize and record a loss allowance or "reserve" for loans. It is not a process or methodology which can be merely reduced to a strict absolute computation, like a mathematical formula to compute taxes. The process and methodology will differ from one company to another and there is no 'one size fits all' format or approach to loss reserving. All of Capitol's banks use a consistent computational template to determine their respective allowances for loan losses. Management believes its process and methodology for determining the allowance for loan losses is appropriate and adequate to properly estimate losses inherent in the loan portfolio at the balance-sheet date; however, actual future losses will differ from amounts considered in the allowance methodology. Further, bank regulatory agencies may have differing perspectives on the process, methodology and adequacy of the allowance for loan losses when examining the banks. At December 31, 2004, Capitol's allowance for loan losses approximated 1.40% of portfolio loans outstanding. Based on portfolio loans outstanding at that

date, any 1 basis-point (.01%) change in the allowance would have an approximate \$269,000 impact on the allowance for loan losses and income before income taxes.

Accounting for stock options. Like many companies, Capitol has granted stock options to its officers and directors and, as permitted under existing accounting rules, has not treated stock options as an element of compensation expense. This is because Capitol has used the so-called intrinsic-value method for accounting for stock options which ascribes zero value and expense to stock options at the date granted or over the life of the stock option, because Capitol's stock options have been granted with an exercise price equal to the fair value of CBC's common stock at the grant date. When using that method, Capitol has been required to disclose what the fair value of the stock options would be, using a valuation model and a pro forma presentation of what compensation expense would have been recognized if Capitol used that fair value method and expensing alternative.

In December 2004, the standard-setting body responsible for issuing accounting guidance in this area issued its long-awaited revision of the prior accounting standard, which had permitted companies the choice between expense recognition for stock options or Capitol's chosen approach of pro forma disclosure. The new guidance becomes effective for interim periods beginning after June 30, 2005.

In 2004, Capitol granted stock options with an aggregate estimated fair value of \$6.6 million. If the stock options granted had been recorded as compensation expense, net income for 2004 would have been \$22.4 million or \$1.51 per diluted share.

It is important to point out, however, that the pro-forma effect of expensing 2004 stock option grants does not give effect to whether the accounting rule change would have had any impact on the level or structure of stock option grant activity. It is also impossible to speculate at the time of this writing what impact the new accounting rules will have on future stock option grants.

While the new rules apply prospectively to stock options granted after the 2005 effective date mentioned previously, it also applies to any previously granted, but unvested stock options at that effective date. Effective December 31, 2004, Capitol accelerated the vesting of any previously unvested stock options in anticipation of implementation of the new accounting rules. The accelerated vesting of stock options was done for the purpose of avoiding expense recognition relating to those stock options under the new guidance.

Accounting for goodwill and other intangibles. At December 31, 2004, Capitol had \$41.9 million of goodwill and other intangibles on its balance sheet, which consisted principally of goodwill. Goodwill arises in acquisition accounting. In Capitol's transactions, most of this goodwill is the premium which relates to the share exchange transactions when Capitol has issued its shares of common stock at a modest premium (usually around 50%) over the book value of the minority interest of a subsidiary bank's shares. In 2004, goodwill and other intangibles increased \$7.5 million due to the purchase of First Carolina State Bank and the

premium associated with the share-exchange transactions involving minority interests of two subsidiaries. Current accounting rules require a periodic review of goodwill for potential impairment. If any amount of the goodwill is deemed to be impaired, such amount is to be written off in the period the determination is made. This is an area involving significant judgment. Based on management's review, no amount of goodwill was deemed to be impaired at December 31, 2004.

Classification of trust-preferred securities. Capitol has \$103.3 million of trust-preferred securities outstanding at December 31, 2004. These are a hybrid debt security with a maturity of 30 years (from the date of issue) and are issued by trusts which are wholly-owned by Capitol. New accounting rules in 2004 required the "deconsolidation" of the trusts from Capitol's financial statements and, instead, recording the underlying subordinated debentures as debt obligations on Capitol's consolidated balance sheet. One of the key features of these securities is that they are considered, for regulatory purposes, as an element of capital.

Capitol's Results of Operations

As stated previously, 2004 was another record year of earnings for Capitol with net income of \$26.7 million, a 14.3% increase over the \$23.4 million earned in 2003. 2003's net income was a 40.4% increase over the \$16.7 million earned in 2002. 2002's earnings exceeded the preceding year by 55.4%. For each of these years, the percentage increase in the amount of earnings per share was less than the increase in the amount of earnings due to growth in the Corporation's share base, primarily due to share exchange transactions with minority owners of some of its affiliate banks. The percentage increase in 2004's net income was less than in the preceding two years due to a lower-than-expected first quarter caused by higher loan loss provisions associated with rapid loan growth (and one problem loan relationship) and management's risk management decision to exit certain mutual fund investments at a loss.

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The following table summarizes for each of Capitol's banks, and on a consolidated basis, net income and the related rates of return on average equity and assets, where applicable (in \$1,000s):

	Net Income			Return on Average Equity			Return on Average Assets		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
<i>Eastern Regions:</i>									
Great Lakes Region:									
Ann Arbor Commerce Bank	\$ 4,234	\$ 4,800	\$ 5,022	16.24%	19.45%	22.40%	1.30%	1.52%	1.72%
Brighton Commerce Bank	1,091	1,104	973	13.09%	15.28%	15.26%	1.11%	1.29%	1.28%
Capitol National Bank	3,602	3,575	3,176	20.77%	22.84%	22.68%	1.59%	1.71%	1.69%
Detroit Commerce Bank	163	(440)	(517)	2.91%			0.27%		
Elkhart Community Bank	703	422	257	9.76%	7.33%	5.48%	1.17%	0.61%	0.61%
Goshen Community Bank	405	386	125	6.34%	8.18%	2.83%	0.83%	0.91%	0.36%
Grand Haven Bank	(412)	1,670	1,924		15.43%	20.51%		1.29%	1.67%
Kent Commerce Bank	578	821	992	7.01%	10.28%	13.72%	0.70%	1.06%	1.33%
Macomb Community Bank	867	262	530	9.83%	2.91%	5.47%	0.93%	0.29%	0.60%
Muskegon Commerce Bank	1,516	1,427	1,472	16.25%	16.38%	18.68%	1.70%	1.68%	1.83%
Oakland Commerce Bank	1,014	1,439	1,414	10.14%	15.14%	16.01%	0.77%	1.16%	1.32%
Paragon Bank & Trust	1,073	891	771	9.53%	8.36%	8.04%	1.00%	0.84%	0.77%
Portage Commerce Bank	<u>2,862</u>	<u>2,393</u>	<u>2,005</u>	20.54%	20.78%	18.69%	1.66%	1.63%	1.49%
Great Lakes Region Total	17,696	18,750	18,144						
First Carolina State Bank ⁽¹⁾	445			4.31%			0.66%		
<i>Western Regions:</i>									
Southwest Region:									
Arrowhead Community Bank	758	442	117	12.53%	9.77%	2.70%	1.14%	0.85%	0.27%
Bank of Las Vegas	224	(8)	(611)	3.65%			0.41%		
Bank of Tucson	2,962	2,776	2,312	24.69%	25.27%	21.87%	1.86%	1.93%	1.99%
Black Mountain Community Bank	1,428	914	439	16.20%	14.23%	9.26%	1.50%	1.32%	0.81%
Camelback Community Bank	554	567	714	6.24%	6.73%	9.74%	0.68%	0.65%	0.90%
Desert Community Bank	634	389	209	8.18%	6.39%	4.16%	1.05%	0.68%	0.35%
East Valley Community Bank	219	(279)	(336)	5.12%			0.49%		
Mesa Bank	1,659	1,366	848	22.83%	19.48%	14.51%	1.91%	1.98%	1.44%
Red Rock Community Bank	806	(69)	243	6.47%		2.71%	0.75%		0.26%
Southern Arizona Community Bank	1,291	1,152	668	15.47%	15.60%	10.67%	1.54%	1.35%	0.94%
Sunrise Bank of Albuquerque	770	664	(40)	12.53%	15.45%		1.09%	1.14%	
Sunrise Bank of Arizona	2,674	1,138	(194)	23.27%	15.61%		2.03%	1.15%	
Valley First Community Bank	310	282	113	5.11%	4.85%	1.99%	0.60%	0.64%	0.23%
Yuma Community Bank	<u>915</u>	<u>473</u>	<u>147</u>	15.59%	11.96%	4.05%	1.74%	1.11%	0.43%
Southwest Region Total	15,204	9,807	4,629						
California Region:									
Bank of Escondido	(186)	(491)							
Napa Community Bank	579	290	(609)	6.80%	3.64%		0.87%	0.64%	
Point Loma Community Bank ⁽²⁾	(703)								
Sunrise Bank of San Diego	<u>1,104</u>	<u>498</u>	<u>342</u>	11.26%	6.40%	4.53%	1.58%	0.85%	0.68%
California Region Total	794	297	(267)						
Other, net	<u>(7,423)</u>	<u>(5,474)</u>	<u>(5,853)</u>						
Consolidated totals	<u>\$26,716</u>	<u>\$23,380</u>	<u>\$16,653</u>	<u>11.25%</u>	<u>12.97%</u>	<u>13.33%</u>	<u>0.91%</u>	<u>0.91%</u>	<u>0.75%</u>

(1) Acquired effective April 1, 2004.

(2) Commenced operations in August 2004 and is 51%-owned by First California Southern Bancorp, a majority-owned subsidiary of Capitol.

The Eastern Regions' performance in 2004 was adversely affected by higher than normal levels of nonperforming loans, resulting in larger provisions for loan losses. The Western Regions' performance for the periods has increased significantly as its younger banks have reached a level of maturity which generate higher earnings.

The principal revenue source for the Corporation's banks is interest income from loans. Total interest income or total interest expense is of little significance individually. Net interest income is the total of all interest income minus all interest expense. This is an important measure that is used to help determine the amount of net operating revenues for financial institutions. Net operating revenue is the sum of net interest income and noninterest income.

Net interest income totaled \$131.6 million in 2004, a 14.5% increase over the \$114.9 million reported in 2003. This increase is a combination of several factors. In total, net interest income increased \$16.7 million, which was comprised of an increase in interest income of about \$14.7 million and a decrease in interest expense of about \$2.0 million. These variances can be analyzed further in terms of their association with changes in interest rates versus changes in volume of the interest-bearing asset or liability. For example, the net increase in interest income is the result of approximately \$25.6 million of additional interest income from higher levels of loans outstanding in 2004 (i.e., volume), but that increase was offset by \$10.9 million in lower levels of interest income due to decreased rates as loans repriced or were refinanced at lower rates in 2004. The decrease in interest expense in 2004 is associated with lower rates paid on time deposits exceeding the amount of interest paid on higher levels of interest-bearing accounts.

Net interest income increased about \$14.3 million in 2003. Most of that net increase came from decreased interest expense, primarily associated with lowered interest rates on deposits. In 2003, the net change in interest income compared to 2002 was small, which was the result of income growth coming from loan portfolio growth largely offset by lower interest rates during that period.

With the addition of noninterest income, total net operating revenue approximated \$150.8 million in 2004, \$135.0 million in 2003 and \$115.6 million in 2002. Noninterest income for these periods was \$19.3 million, \$20.1 million and \$15.0 million, respectively.

Noninterest income increased significantly in 2003 and 2002 largely as the result of fees from the origination of non-portfolio residential mortgage loans, but decreased in 2004 due to lower revenues from this source. In 2004, 2003 and 2002, this revenue amounted to \$5.6 million, \$8.7 million and \$6.8 million, respectively. A very substantial portion of this mortgage fee revenue has been derived from mortgage refinancing activity, during periods of record-low interest rates. The future of interest rates is uncertain and it is reasonable to expect that this revenue source may decrease, perhaps materially, if there are adverse changes in mortgage interest rates or other unfavorable conditions impacting the residential housing market.

The provision for loan losses approximated \$12.7 million, \$9.9 million and \$12.7 million in 2004, 2003 and 2002, respectively. The amount of the provision for loan losses is determined based on management's analysis of amounts necessary for the allowance for loan losses; this is discussed in greater detail later in the *Financial Position* section of this narrative.

Noninterest expense totaled \$97.8 million, \$87.0 million and \$76.5 million in 2004, 2003 and 2002, respectively. In total, these expenses increased 12.5% in 2004, 13.6% in 2003 and 19.7% in 2002. The lower rate of increase in 2004 and 2003 is the result of a slower pace of adding new banks (only three banks were added during 2004 and 2003). Increases in the components of noninterest expense are primarily associated with added staffing and other costs associated with growing young banks and adding new banks. The more significant elements of other noninterest expense consisted of the following:

	<u>2004</u>	<u>2003</u> (In \$1,000s)	<u>2002</u>
Professional fees	\$ 2,046	\$ 1,549	\$ 1,431
Advertising	1,981	1,756	1,543
Paper, printing and supplies	1,697	1,728	1,589
Bank services (ATMs, telephone banking and Internet banking)	1,123	1,094	916
Taxes other than income taxes	1,010	909	713
Communications	996	944	780
Other	<u>11,368</u>	<u>11,138</u>	<u>11,040</u>
Total	<u>\$ 20,221</u>	<u>\$ 19,118</u>	<u>\$ 18,012</u>

The increase in professional fees in 2004 largely relates to added compliance costs associated with the Sarbanes-Oxley Act.

The Corporation's effective tax rate was 36.4% in 2004, 36.7% in 2003 and 35.3% in 2002. The statutory federal income tax rate applicable to Capitol is currently 35%. The effective tax rate includes state income taxes, but excludes taxes incurred in states which are based on measures other than income.

Capitol's Financial Position

Capitol completed 2004, as in years past, in a strong financial position. Total assets grew to \$3.1 billion, from \$2.7 billion at the end of 2003 and just over \$2.4 billion at the beginning of 2003. Key to the balance-sheet strength of Capitol is its liquidity (cash and cash equivalents of \$231.1 million or 7.5% of total assets) and its total capital position (subordinated debentures, minority interests in consolidated subsidiaries and stockholders' equity totaling approximately \$392.5 million or 12.7% of total assets) at December 31, 2004. Both of those key elements are discussed in the next section, *Liquidity, Capital Resources and Capital Adequacy*.

When looking at Capitol's financial position, as shown in its consolidated balance sheet, it is clear that the single largest asset category is portfolio loans. Accordingly, the narrative in this section is devoted primarily to loans.

Net portfolio loans (total portfolio loans minus the allowance for loan losses) approximated \$2.7 billion at December 31, 2004 and \$2.2 billion at December 31, 2003. These amounts approximated 86% of total consolidated assets at December 31, 2004 and 81% at December 31, 2003.

The banks emphasize commercial loans, consistent with their focus on lending to local entrepreneurs, professionals and other businesses. All of Capitol's banks use an enterprise-wide credit policy; however, as emphasized earlier, all credit decisions are made at the local level at each community bank. The utilization of a consistent enterprise-wide credit policy has several key benefits to Capitol and its banks, such as procedural guidance for:

- Loan underwriting and documentation.
- Credit granting authorities within the bank.
- Acceptable collateral and loan structuring.
- Loan participations when proposals exceed individual bank limitations.
- Collections and workouts.
- Evaluating and documenting the adequacy of the allowance for loan losses.
- Establishing corporate credit administration resources to aid the banks when needed.

As part of the banks' emphasis on commercial lending, commercial real estate is frequently sought as the primary source of collateral for commercial loans. This emphasis on use of commercial real estate as collateral has been a consistent practice of Capitol and its banks from their earliest days of operation, based on the use of conservative loan-to-value ratios, avoidance of aggressively over-leveraged real estate development projects and that, even in soft economies, commercial real estate has tended to have substantially less loss potential than other types of business-asset collateral, such as receivables and inventory.

A potentially negative aspect of real estate as a primary source of collateral for commercial loans is that when some commercial loans develop performance difficulties and reach nonperforming status (i.e., becoming 90 days past due or being placed on nonaccrual status), the resolution period is longer because the real estate security will inevitably take an extended period to liquidate. In contrast, a commercial loan secured by receivables and inventory which becomes nonperforming tends to have a higher loss potential due to probable dissipation of collateral value prior to reaching nonaccrual status.

Nonperforming loans approximated \$28.5 million and \$26.9 million at December 31, 2004 and 2003, respectively. Such amounts approximated 1.06% and 1.20% of portfolio loans and 0.92% and 0.98% of total assets, respectively. Of the nonperforming loans at December 31, 2004, about 67% were real-estate secured. Management believes that nonperforming loans have been properly considered in its evaluation of the adequacy of the allowance for loan losses, which is discussed later in this narrative.

In addition to the identification of nonperforming loans involving borrowers with payment performance difficulties (i.e., nonaccrual loans and loans past-due 90 days or more), management utilizes an internal loan review process to identify other potential problem loans which may warrant additional monitoring or other attention. This loan review process is a continuous activity which periodically updates internal loan classifications. At inception, all loans are individually assigned a classification which grade the credits on a risk basis, based on the type and discounted value of collateral, financial strength of the borrower and

guarantors and other factors such as nature of the borrowers' business climate, local economic conditions and other subjective factors. The loan classification process is fluid and subjective.

Potential problem loans include loans which are generally performing as agreed; however, because of loan review's and/or lending staff's risk assessment, increased monitoring is deemed appropriate. In addition, some loans are identified for monitoring because of specific performance issues or other risk factors requiring closer management and development of specific remedial action plans.

At December 31, 2004, potential problem loans (including nonperforming loans) approximated \$113.2 million or about 4.2% of total consolidated portfolio loans. Such totals typically approximate 4% to 5% of loans outstanding and are an important part of management's ongoing and augmented loan review activities which are designed to early-identify loans which warrant close monitoring at the bank and corporate credit-administration levels. It is important to note that these potential problem loans do not necessarily have significant loss exposure (nor are they necessarily deemed 'impaired'), but rather are identified by management in this manner to aid in loan administration and risk management. Management believes these loans to be adequately considered in its evaluation of the adequacy of the allowance for loan losses.

As was noted in the *Critical Accounting Policies* section of this narrative, the discussion regarding use of estimates in determining the allowance for loan losses is very important to an understanding of Capitol's consolidated financial statements. Simply stated, the allowance for loan losses is management's estimate of loan losses inherent in the loan portfolio at the balance-sheet date. The allowance for loan losses is increased by provisions for loan losses which are charged against operations and reduced by loan write-offs which are charged against the allowance. There are many ways to estimate losses or 'loss reserves' and, arguably, there is no one 'right' way.

Capitol had 32 separately chartered banks at year-end 2004. Each bank separately documents the adequacy of its respective allowance for loan losses. As mentioned previously, Capitol has a uniform, enterprise-wide credit policy which, among other things, provides the banks guidance on evaluating and documenting the adequacy of the allowance for loan losses. Essentially, a standardized computational template is used consistently for all of Capitol's banks. The template factors in allowance elements for all portfolio loan categories for performing loans, nonperforming loans, watch credits and environmental factors. While a standardized template is utilized, no computational methodology relieves management from applying judgment in determining the amount of the allowance needed at the bank level. Further, the combined results of the banks' separate analyses are evaluated at the Capitol, or parent, level on a judgmental basis. The process used to evaluate and determine the adequacy of the allowance for loan losses is labor intensive and requires significant judgment.

The following table summarizes portfolio loans, the allowance for loan losses and nonperforming loans for each of the banks, and on a consolidated basis:

	Total Portfolio Loans		Allowance for Loan Losses		Nonperforming Loans		Allowance as a % of Total Portfolio Loans	
	2004	2003	2004	2003	2004	2003	2004	2003
<i>Eastern Regions:</i>								
Great Lakes Region:								
Ann Arbor Commerce Bank	\$ 297,936	\$ 287,766	\$ 3,907	\$ 3,912	\$ 2,460	\$ 2,926	1.31%	1.36%
Brighton Commerce Bank	95,408	79,554	969	795	1,035	1,000	1.02%	1.00%
Capitol National Bank	196,519	177,599	2,723	2,211	2,053	1,440	1.39%	1.24%
Detroit Commerce Bank	66,280	38,363	806	595	338	633	1.22%	1.55%
Elkhart Community Bank	63,987	48,388	712	616	277	89	1.11%	1.27%
Goshen Community Bank	48,059	39,810	644	578	703	101	1.34%	1.45%
Grand Haven Bank	109,612	101,645	2,522	1,887	7,264	3,178	2.30%	1.86%
Kent Commerce Bank	86,090	76,093	1,269	829	2,445	651	1.47%	1.09%
Macomb Community Bank	91,173	81,776	1,327	1,102	1,768	1,973	1.46%	1.35%
Muskegon Commerce Bank	88,692	79,223	904	1,026	1,524	2,677	1.02%	1.30%
Oakland Commerce Bank	107,037	93,920	1,850	1,459	2,402	3,022	1.73%	1.55%
Paragon Bank & Trust	96,428	89,499	1,350	1,365	783	1,446	1.40%	1.53%
Portage Commerce Bank	170,479	150,783	1,977	1,915	2,820	2,746	1.16%	1.27%
Great Lakes Region Total	1,517,700	1,344,419	20,960	18,290	25,872	21,882		
First Carolina State Bank ⁽¹⁾	51,867		525		11		1.01%	
<i>Western Regions:</i>								
Southwest Region:								
Arrowhead Community Bank	62,737	46,135	620	527	29		0.99%	1.14%
Bank of Las Vegas	41,134	27,398	425	337			1.03%	1.23%
Bank of Tucson	115,694	102,244	1,170	1,149	455		1.01%	1.12%
Black Mountain Community Bank	84,163	63,184	1,014	725	368	571	1.20%	1.15%
Camelback Community Bank	75,146	66,260	1,186	882		140	1.58%	1.33%
Desert Community Bank	58,751	42,543	722	626	107	675	1.23%	1.47%
East Valley Community Bank	42,614	31,916	520	440		10	1.22%	1.38%
Mesa Bank	85,561	61,714	800	664		375	0.94%	1.08%
Red Rock Community Bank	72,938	71,138	1,714	1,812	762	2,613	2.35%	2.55%
Southern Arizona Community Bank	72,226	69,965	736	767			1.02%	1.10%
Sunrise Bank of Albuquerque	59,766	54,078	895	593	459	14	1.50%	1.10%
Sunrise Bank of Arizona	118,617	111,148	1,400	1,337	111	59	1.18%	1.20%
Valley First Community Bank	49,518	34,769	469	491			0.95%	1.41%
Yuma Community Bank	41,460	31,409	465	437			1.12%	1.39%
Southwest Region Total	980,325	813,901	12,136	10,787	2,291	4,457		
California Region:								
Bank of Escondido	33,166	9,273	350	120			1.06%	1.29%
Napa Community Bank	53,033	35,033	720	492			1.36%	1.40%
Point Loma Community Bank ⁽²⁾	8,590		88				1.02%	
Sunrise Bank of San Diego	46,945	43,410	415	577	297	533	0.88%	1.33%
California Region Total	141,734	87,716	1,573	1,189	297	533		
Other, net	1,278	1,404	2,378	1,138				
Consolidated totals	<u>\$2,692,904</u>	<u>\$2,247,440</u>	<u>\$ 37,572</u>	<u>\$ 31,404</u>	<u>\$ 28,471</u>	<u>\$ 26,872</u>	<u>1.40%</u>	<u>1.40%</u>

(1) Acquired effective April 1, 2004.

(2) Commenced operations in August 2004 and is 51%-owned by First California Southern Bancorp, a majority-owned subsidiary of Capitol.

At December 31, 2004, the consolidated allowance for loan losses approximated \$37.6 million or 1.40% of total portfolio loans outstanding, compared with \$31.4 million or 1.40% at December 31, 2003 and \$29.0 million or 1.45% at the beginning of 2003. The allowance ratio was increased significantly in 2002 in concert with higher estimated losses which were subsequently recognized as loan charge-offs. As stated earlier, the allowance is based on management's analysis of inherent losses in the portfolio at the balance sheet date, after giving effect to those charge-offs and is deemed adequate as of that date.

There are other asset categories, such as loans held for resale (\$43.1 million and \$43.0 million at December 31, 2004 and 2003, respectively). Those are loans which are presold to the secondary market (mainly home mortgages) that generally are collected in 30-60 days. There is also a modest amount of investment securities on the balance sheet (\$42.4 million and \$93.2 million at December 31, 2004 and 2003, respectively). All other asset categories are individually less than \$50 million at December 31, 2004 and 2003.

The primary source of funding of loans is deposits, which is discussed in the next section of this narrative.

Liquidity, Capital Resources and Capital Adequacy

Asset liquidity for financial institutions typically consists of cash and cash equivalents, loans held for resale and investment securities available for sale. These categories totaled \$302 million at year-end 2004, or about 10% of total assets. This compares to \$410 million or about 15% of total assets at year-end 2003. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests and various other commitments discussed in the accompanying notes to consolidated financial statements. Liquidity varies significantly daily, based on customer activity.

Most of the investment securities portfolio is classified as available for sale, although the banks generally have not sold investments to meet liquidity needs. Also, to the extent warranted, the banks may sell loans from time to time. During 2004, sales of investment securities available for sale approximated \$59.6 million, an unusually high level, compared with \$25.5 million in 2003 and \$8.7 million in 2002. Proceeds from sales of investment securities available for sale included about \$57 million of mutual fund investments which management decided to liquidate, based on its first quarter review of those investments from a risk-management perspective, and for which a loss approximating \$500,000 was incurred as of March 31, 2004.

Loans held for resale, as previously mentioned, approximated \$43.1 million at December 31, 2004. These loans are residential real estate mortgages originated by the banks, primarily through Capitol's mortgage affiliate, Amera Mortgage Corporation. These loans are subsequently sold into the secondary market, rather than being held in the banks' portfolios, to reduce interest rate risk. Mortgage loan origination volume in 2004 decreased 43%, to approximately \$715.2 million compared to \$1.3 billion in 2003 and \$891.5 million in 2002. The decrease in volume was primarily due to an increase in interest rates in 2004 after record low interest rates in 2003 and 2002. Future volume will depend on whether interest rates remain low and the strength of residential real estate market conditions.

The primary source of funds for the banks is deposits. The banks emphasize interest-bearing time deposits as part of their funding strategy. The banks also seek noninterest-bearing deposits, or checking accounts, which reduce the banks' cost of funds. Noninterest-bearing deposits were about 20% of total deposits at year-end 2004 (about 19% at year-end 2003) and increased \$68 million, or 16%, during the year.

In recent periods, many banks within the industry have experienced some competitive challenges in obtaining additional deposits to fuel growth. Capitol's banks have had similar experiences in their individual markets. As depositors have wider access to the Internet and other real-time interest rate monitoring resources, deposit pricing has become more competitive. Deposit growth is achievable, but at a competitive price, with tight net interest margins, especially during these most recent periods of low interest rates. The banks do not generally rely on brokered deposits as a key funding source (approximately \$181 million at year-end 2004 or 9% of interest-bearing deposits compared to 10% in 2003); however, brokered deposits are a ready resource to help meet urgent funding needs, such as loan commitments (which are discussed in greater detail in Note O of the consolidated financial statements).

To supplement their funding sources, some of the banks have lines of credit from the Federal Home Loan Bank system. At year-end 2004, a total of approximately \$154 million (\$93 million at year-end 2003) was borrowed under those facilities and additional borrowing availability approximated \$106 million. Some of the banks also have smaller lines of credit with their correspondent banks. Borrowings under these facilities are generally at short-term market rates of interest and, although the repayment dates can be extended, are generally outstanding for brief periods of time.

Capitol has a credit facility aggregating \$25 million from an unaffiliated bank. At year-end 2004 and 2003, no amounts were borrowed under this facility.

Capitol's longer-term contractual obligations are disclosed in the notes to the consolidated financial statements. Such obligations consist principally of time deposits of the banks, debt and lease obligations and trust-preferred securities, summarized as follows (in \$1,000s):

	Total	Payments Due by Period			
		Within 1 Year	Within 1-3 Years	Within 3-5 Years	After 5 Years
Time deposits	\$ 964,374	\$ 710,590	\$ 210,268	\$ 42,479	\$ 1,037
Debt obligations	172,534	85,073	51,321	--	36,140
Rent commitments under noncancelable leases	35,073	5,783	11,275	8,232	9,783
Trust-preferred securities	<u>103,300</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>103,300</u>
Total	<u>\$1,275,281</u>	<u>\$ 801,446</u>	<u>\$ 272,864</u>	<u>\$ 50,711</u>	<u>\$ 150,260</u>

Loan commitments of Capitol's banks (stand-by letters of credit and unfunded loans) generally expire within one year. Deposit balances other than time accounts and interest payable on deposits are excluded from the table set forth above; please refer to the later interest-rate sensitivity table regarding all deposit maturities. Other than the items set forth above, there are no individually material contractual obligations, such as purchase obligations.

A significant source of capital has been investments provided by minority shareholders in the subsidiaries which are consolidated for financial reporting purposes. Total minority interests in consolidated subsidiaries amounted to \$39.5 million at year-end 2004, a net increase of \$8.6 million from the \$30.9 million level at year-end 2003. The change in minority interests

in 2004 resulted mainly from Capitol's formation of one new bank-development subsidiary less acquisitions of minority interests of subsidiaries which became wholly-owned in 2004.

One majority-owned bank and one majority-owned bank-development subsidiary became wholly-owned in 2004 and resulted in the issuance of about 347,000 shares of Capitol's common stock. In each of these transactions, the shares acquired from the minority shareholders were exchanged for Capitol's common stock according to fixed, but differing, exchange ratios. In 2003, Capitol similarly completed eight separate share-exchange transactions which resulted in the issuance of approximately 1.3 million shares of Capitol's common stock.

While it is likely that similar share exchange transactions, as a strategy to gain full ownership of some majority-owned affiliates, may occur in the future, any such transactions depend upon whether Capitol (or one of its subsidiary bank holding companies) offers such an exchange and whether minority shareholders vote in favor of it on a transaction-by-transaction basis.

Effective April 1, 2004, Capitol acquired First Carolina State Bank located in Rocky Mount, North Carolina, in a purchase transaction with total consideration approximating \$10 million. Approximately half of the consideration was paid in cash and the remainder consisted of approximately 183,000 previously unissued shares of Capitol's common stock. Capitol has rarely made acquisitions of existing banks. Prior to its acquisition of First Carolina, its most recent acquisition of an existing bank was in 1994.

Total stockholders' equity approximated \$252 million at year-end 2004, an increase of \$33 million for the year. The 2004 increase in stockholders' equity includes earnings (less dividends paid), the previously-mentioned share-exchange transactions and proceeds from the issuance of common stock. The book value per share of common stock was \$17.00 at year-end 2004, compared with \$15.60 at year-end 2003. Cash dividends of \$0.65 were paid in 2004, compared to \$0.51 in 2003 and \$0.44 in 2002. Future payment of dividends is subject to approval by Capitol's board of directors, future operating performance and management's assessment of the consolidated organization's capital adequacy.

Capitol's capital structure consists of these primary elements:

- Trust-preferred securities and related subordinated debentures,
- Minority interests in consolidated subsidiaries, and
- Stockholders' equity.

In 2004, there was one private placement of pooled trust-preferred securities in the amount of \$10 million. In 2003, there were three private placements of pooled trust-preferred securities totaling \$40 million. In June 2002, Capitol participated in the private placement of a pooled trust-preferred security totaling \$3 million. In 2001, Capitol participated in two private placements of pooled trust-preferred securities totaling \$25 million. These securities, along with Capitol Trust I (a \$25 million public offering of trust-preferred securities in 1997), are treated as elements of capital for regulatory purposes. As noted in the accompanying financial

statements, the trusts relating to Capitol's trust-preferred securities are classified as debt obligations and, as noted in the *Critical Accounting Policies* of this narrative, the accounting treatment changed in 2004.

Total capitalization at year-end 2004 amounted to \$392.5 million or 12.7% of total assets. This compares to \$340.7 million or 12.4% at year-end 2003.

Capitol and each of its banks and bank development subsidiaries are subject to a complex series of regulatory rules and requirements which require specific levels of capital adequacy at both the bank level and on a consolidated basis. Under those rules and regulations, banks are categorized as *well capitalized*, *adequately capitalized* or *inadequately capitalized* using several ratio measurements, including a risk-weighting approach to assets and financial commitments. Banks falling into the *inadequately capitalized* category are subject to the prompt corrective action provisions of the FDIC Improvement Act, which can result in significant regulatory agency intervention and other adverse action. Although it is permissible to maintain capital adequacy at the *adequately capitalized* level, Capitol operates with the objective of its banks meeting the *well capitalized* standard. The *well capitalized* banks benefit from lower FDIC deposit insurance costs and less restrictive limitations on some banking activities.

New banks, as a condition of regulatory charter approval, are required to maintain higher ratios of capital adequacy. Generally, they are required to keep a specific ratio of capital-to-average-total-assets of not less than 8% during their first three years of operation.

In the opinion of management, all of the affiliated banks met the criteria to be classified as *well capitalized* at year-end 2004.

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Trends Affecting Operations

The most significant trends which can impact the financial condition and results of operations of financial institutions are changes in market rates of interest and changes in general economic conditions.

Changes in interest rates, either up or down, have an impact on net interest income (plus or minus), depending on the direction and timing of such changes. At any point in time, there is an imbalance between interest rate-sensitive assets and interest rate-sensitive liabilities. This means that when interest rates change, the timing and magnitude of the effect of such interest rate changes can alter the relationship between asset yields and the cost of funds. This timing difference between interest rate-sensitive assets and interest rate-sensitive liabilities is characterized as a “gap” which is quantified by the distribution of rate-sensitive amounts within various time periods in which they reprice or mature. The following table summarizes the consolidated financial position in relation to “gap” at December 31, 2004 (in \$1,000s):

	Interest Rate Sensitivity				Total
	0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years	
ASSETS					
Federal funds sold	\$ 96,390				\$ 96,390
Money market and interest-bearing deposits	8,347	\$ 2,398			10,745
Investment securities	829	7,464	\$ 11,728	\$ 22,342	42,363
Portfolio loans:					
Commercial	1,323,123	192,656	890,741	37,972	2,444,492
Real estate mortgage	131,877	31,498	12,179	1,650	177,204
Installment	8,960	20,026	39,483	2,739	71,208
Loans held for resale	43,143				43,143
Non-earning assets					205,873
Total assets	\$ 1,612,669	\$ 254,042	\$ 954,131	\$ 64,703	\$ 3,091,418
LIABILITIES AND STOCKHOLDERS' EQUITY					
Interest-bearing deposits:					
Time deposits under \$100,000	\$ 62,606	\$ 121,793	\$ 114,390	\$ 739	\$ 299,528
Time deposits \$100,000 and over	284,781	241,410	138,357	298	664,846
All other interest-bearing deposits	844,249	193,194	4,353		1,041,796
Total interest-bearing deposits	1,191,636	556,397	257,100	1,037	2,006,170
Notes payable and short-term borrowings	44,149	40,924	51,321	36,140	172,534
Subordinated debentures (trust-preferred securities)	58,000			45,300	103,300
Noninterest-bearing liabilities					517,735
Minority interests in consolidated subsidiaries					39,520
Stockholders' equity					252,159
Total liabilities and stockholders' equity	\$ 1,293,785	\$ 597,321	\$ 308,421	\$ 82,477	\$ 3,091,418
Interest rate sensitive period gap	\$ 318,884	\$ (343,279)	\$ 645,710	\$ (17,774)	
Interest rate sensitive cumulative gap	\$ 318,884	\$ (24,395)	\$ 621,315	\$ 603,541	
Period rate sensitive assets/period rate sensitive liabilities	1.25	0.43	3.09	0.78	
Cumulative rate sensitive assets/cumulative rate sensitive liabilities	1.25	0.99	1.28	1.26	
Cumulative gap to total assets	10.32 %	(0.79) %	20.10 %	19.52 %	

The “gap” changes daily based upon changes in the underlying assets and liabilities at the banks. Analyzing exposure to interest rate risk is prone to imprecision because the “gap” is constantly changing, the “gap” differs at each of the banks and it is difficult to predict the timing, amount and direction of future changes in market interest rates and the potential corresponding effect on customer behavior.

The banks endeavor to manage and monitor interest rate risk in concert with market conditions and risk parameters. Management strives to maintain a reasonably balanced position of interest rate-sensitive assets and liabilities. Capitol and its banks have not engaged in speculative positions, for example, through the use of derivatives, in anticipation of interest rate movements. In periods of relatively lower interest rates, the banks emphasize variable rate loans and time deposits to the extent possible in a competitive environment; however, competitive influences often result in making fixed rate loans, although the banks seek to limit the duration of such loans. These most recent periods of record low interest rates have created a huge volume of fixed-rate mortgage refinancing activity; those loans are sold to the secondary market and are not retained for the banks’ loan portfolios. Similarly, low interest rates generally make competition more intense for deposits, since loan demand will typically increase during periods of lower rates and, accordingly, result in higher interest costs on deposits as competitors bid-up rates, adversely impacting interest margins. Future interest rates and the impact on earnings are difficult to predict. In addition to interest rate risk relating to interest-bearing assets and liabilities, changes in interest rates also can impact future transaction volume of loans and deposits at the banks. For activities which are influenced by levels of interest rates for transaction volume (for example, origination of residential mortgage loans), pricing margins and demand can become impacted significantly by changes in interest rates.

As a means of monitoring and managing exposure to interest rate risk, management uses a computerized simulation model which is intended to estimate pro forma effects of changes in interest rates. Using the simulation model, the following table illustrates, on a consolidated basis, changes which would occur in annual levels of interest income, interest expense and net interest income (in \$1,000s) assuming both one hundred and two hundred basis point (“bp”) parallel increases and decreases in interest rates:

	Pro Forma Assuming No Change in Interest Rates	Pro Forma Effect of Interest Rate Increases		Pro Forma Effect of Interest Rate Decreases	
		+100 bp	+200 bp	-100 bp	-200 bp
Interest income	\$ 208,382	\$ 228,737	\$ 249,142	\$ 193,831	\$ 181,928
Interest expense	<u>57,422</u>	<u>72,697</u>	<u>87,972</u>	<u>42,743</u>	<u>31,904</u>
Net interest income	<u>\$ 150,960</u>	<u>\$ 156,040</u>	<u>\$ 161,170</u>	<u>\$ 151,088</u>	<u>\$ 150,024</u>

The pro forma analysis above is intended to quantify theoretical changes in interest income based on stated assumptions. The pro forma analysis excludes the effect of numerous other variables such as borrowers’ ability to repay loans, the ability of banks to obtain deposits in a radically changed interest-rate environment and how management would revise its asset and liability management priorities in concert with rate changes.

While the pro forma analysis above is intended to estimate the impact of an immediate 100 and 200 basis point change in rates, actual results will be different. Those results will differ (and may be materially different) because a sudden rate change in market rates does not result in an instantaneous parallel shift in rates on loans and deposits at banks. Further, any financial model intended to estimate the impact of interest rate changes will not necessarily incorporate other variables, including management's efforts to manage its asset and liability interest rate sensitivity, or customer behavior.

General economic conditions also have a significant impact on both the results of operations and the financial condition of financial institutions. Local economic conditions, and to some extent national economic conditions, have a significant impact on levels of loan demand as well as the ability of borrowers to repay loans and the availability of funds for customers to make deposits.

At the time this narrative was written, uncertainties of domestic economic health and global stability preclude prediction of near-term trends and their potential effects.

Continuing consolidation of the banking industry on a national basis, and in the markets of Capitol's banks, has presented opportunities for growth. As a result of consolidation of the banking industry and the conversion of customer relationships into perceived 'commodities' by the larger banks, many customer relationships have been displaced, generating opportunities for development by Capitol's banks. For many retail customers, banking services have become a commodity in an environment that is dominated by larger mega-bank or mass-merchandising institutions. For the professional, entrepreneur and other customers seeking a more service-oriented, customized banking relationship, Capitol's banks fill that need through their focus on single-location banks with full, local decision-making authority. As Capitol's banks focus on service delivery and keeping their size at a manageable level, only a modest market share of deposits and loan activity is necessary to achieve profitability and investor-oriented earnings performance.

Start-up banks generally incur operating losses during their early periods of operations. Recently-formed start-up banks will detract from consolidated earnings performance and additional start-up banks formed in 2005 and beyond will similarly negatively impact short-term profitability. On a consolidated basis, such operating losses reduce net income by the pro rata share of Capitol's ownership percentage in those banks. Capitol reduces the net income impact of early-period losses of start-up banks through its unique ownership structure of substantially less than 100% of those banks either directly or indirectly through bank development subsidiaries. When those banks become profitable, their operating results will contribute to consolidated earnings to the extent of Capitol's ownership percentage.

Commercial banks continue to be subject to significant regulatory requirements which impact current and future operations. In addition to the extent of regulatory interaction with financial institutions, extensive rules and regulations governing lending activities, deposit gathering and capital adequacy (to name a few), translate into a significant cost burden of financial institution regulation. Such costs include the significant amount of management

time and expense which is incurred in maintaining compliance and developing systems for compliance with those rules and regulations as well as the cost of examinations, audits and other compliance activities. The future of financial institution regulation, and its costs, is uncertain and difficult to predict.

Premiums for FDIC insurance have historically been a significant cost of doing business as financial institutions, but in the last several years, deposit insurance premiums have been maintained at a stable and modest level. Future deposit insurance premium levels are difficult to predict inasmuch as deposit insurance premiums will be determined based on general economic conditions, the relative health of the banking and financial institution industry and other unpredictable factors. It is reasonable to expect that deposit insurance premiums may increase at some point in the future.

International bank regulatory agencies are currently contemplating revisions to the existing risk-based capital adequacy framework through the Basel II proposals. As currently proposed, management does not expect those proposals to have a material impact on Capitol and its banks.

New Accounting Standards

There were several new accounting standards which were issued or became effective in 2004, in addition to some which have later effective dates. They are listed and discussed in Note B of the consolidated financial statements, beginning on page F-40.

Recent Developments

In late 2003, Capitol formed a new bank-development subsidiary, Capitol Development Bancorp Limited I (“CDBLI”). In early 2004, a second bank-development subsidiary was formed, Capitol Development Bancorp Limited II (“CDBLII”). Both CDBLI and CDBLII were each capitalized with two classes of common stock, voting and nonvoting. All of the voting common stock (an aggregate investment of \$1 million for each entity) is owned by Capitol. All of the nonvoting common stock (an aggregate investment of approximately \$10.9 million as to CDBLI and \$9.9 million as to CDBLII) was sold in private offerings to accredited investors, some of whom are related parties of Capitol. CDBLI and CDBLII will be engaged in bank development activities, either on a *de novo* basis or through acquisition opportunities. CDBLI and CDBLII were inactive at December 31, 2004 and have been included as consolidated subsidiaries of Capitol.

CDBLI acquired a controlling interest in its first *de novo* bank subsidiary in early January 2005. Bank of Michigan, located in Farmington Hills, opened on January 10, 2005.

In addition to Bank of Michigan, regulatory applications were pending at December 31, 2004 for additional *de novo* banks to be formed in the states of Michigan and Washington. Further, in early 2005, applications were filed for the formation of *de novo* banks in the states of California, Colorado, Georgia, Illinois and North Carolina, in addition to a proposed acquisition of a small bank in the state of Georgia. Bank development activities in early 2005 in other regions of the country were in various stages of progress.

***Report on Management's Assessment of
Internal Control Over Financial Reporting***

Capitol Bancorp Ltd. is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements and notes included in this annual report have been prepared in conformity with United States generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

We, as management of Capitol Bancorp Ltd., are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with United States generally accepted accounting principles. The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Capitol's Audit Committee, consisting entirely of independent directors, meets regularly with management, internal auditors and the independent registered public accounting firm, and reviews audit plans and results, as well as management's actions taken in discharging responsibilities for accounting, financial reporting, and internal control. BDO Seidman, LLP, independent registered public accounting firm, and the internal auditors have direct and confidential access to Capitol's Audit Committee at all times to discuss the results of their examinations.

Management assessed Capitol's system of internal control over financial reporting as of December 31, 2004, in relation to criteria for effective internal control over financial reporting as described in Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concluded that, as of December 31, 2004, its system of internal control over financial reporting was effective and met the criteria of the Internal Control – Integrated Framework. BDO Seidman, LLP, independent registered public accounting firm, has issued an attestation report on management's assessment of Capitol's internal control over financial reporting.



Joseph D. Reid
Chairman and CEO



Lee W. Hendrickson
Chief Financial Officer

Lansing, Michigan
March 4, 2005



Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Capitol Bancorp Ltd.

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control Over Financial Reporting, that Capitol Bancorp Ltd. maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Capitol Bancorp Ltd.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that Capitol Bancorp Ltd. maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, Capitol Bancorp Ltd. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2004 of Capitol Bancorp Ltd. and our report dated March 4, 2005 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Grand Rapids, Michigan
March 4, 2005



Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Capitol Bancorp Ltd.

We have audited the accompanying consolidated balance sheets of Capitol Bancorp Ltd. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Capitol Bancorp Ltd. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Capitol Bancorp Ltd.'s internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 4, 2005 expressed an unqualified opinion thereon.

Grand Rapids, Michigan
March 4, 2005

Consolidated Balance Sheets

	- December 31 -	
	2004	2003
	(in \$1,000s)	
ASSETS		
Cash and due from banks	\$ 123,969	\$ 145,896
Money market and interest-bearing deposits	10,745	13,570
Federal funds sold	<u>96,390</u>	<u>124,157</u>
Cash and cash equivalents	231,104	283,623
Loans held for resale	43,143	43,001
Investment securities—Note C:		
Available for sale, carried at market value	28,172	83,386
Held for long-term investment, carried at amortized cost which approximates market value	<u>14,191</u>	<u>9,821</u>
Total investment securities	42,363	93,207
Portfolio loans, less allowance for loan losses of \$37,572 in 2004 and \$31,404 in 2003—Note D	2,655,332	2,216,036
Premises and equipment—Note F	32,661	24,793
Accrued interest income	10,447	9,533
Goodwill and other intangibles—Note B	41,943	34,449
Other assets	<u>34,425</u>	<u>32,420</u>
TOTAL ASSETS	<u>\$3,091,418</u>	<u>\$2,737,062</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	\$ 503,902	\$ 435,599
Interest-bearing—Note G	<u>2,006,170</u>	<u>1,853,065</u>
Total deposits	2,510,072	2,288,664
Debt obligations:		
Notes payable and short-term borrowings—Note H	172,534	92,774
Subordinated debentures—Note I	<u>100,845</u>	<u>90,816</u>
Total debt obligations	273,379	183,590
Accrued interest on deposits and other liabilities	<u>16,288</u>	<u>14,965</u>
Total liabilities	2,799,739	2,487,219
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES—		
Note A	39,520	30,946
STOCKHOLDERS' EQUITY—Notes B, J and P		
Common stock, no par value, 25,000,000 shares authorized; issued and outstanding:		
2004—14,828,750 shares		
2003—14,027,982 shares	196,271	180,957
Retained earnings	60,476	43,135
Market value adjustment (net of tax effect) for investment securities available for sale (accumulated other comprehensive income)	<u>(36)</u>	<u>(200)</u>
	256,711	223,892
Less unearned compensation regarding restricted stock and other	<u>(4,552)</u>	<u>(4,995)</u>
Total stockholders' equity	<u>252,159</u>	<u>218,897</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$3,091,418</u>	<u>\$2,737,062</u>

See notes to consolidated financial statements.

Consolidated Statements of Income

	- Year Ended December 31 -		
	2004	2003	2002
	(in \$1,000s, except per share data)		
Interest income:			
Portfolio loans (including fees)	\$ 173,376	\$ 157,114	\$ 149,785
Loans held for resale	2,150	3,299	2,674
Taxable investment securities	1,331	749	1,422
Federal funds sold	1,620	1,344	1,376
Other	<u>612</u>	<u>1,910</u>	<u>1,197</u>
Total interest income	179,089	164,416	156,454
Interest expense:			
Deposits	36,695	41,260	47,848
Debt obligations and other	<u>10,801</u>	<u>8,230</u>	<u>8,012</u>
Total interest expense	<u>47,496</u>	<u>49,490</u>	<u>55,860</u>
Net interest income	131,593	114,926	100,594
Provision for loan losses—Note D	<u>12,708</u>	<u>9,861</u>	<u>12,676</u>
Net interest income after provision for loan losses	118,885	105,065	87,918
Noninterest income:			
Service charges on deposit accounts	4,381	4,319	4,020
Trust fee income	3,456	2,614	2,434
Fees from origination of non-portfolio residential mortgage loans	5,581	8,710	6,837
Realized gains (losses) on sale of investment securities available for sale	(603)	4	24
Gains on sale of government-guaranteed loans	3,778	3,635	1,667
Other	<u>2,659</u>	<u>805</u>	<u>--</u>
Total noninterest income	19,252	20,087	14,982
Noninterest expense:			
Salaries and employee benefits	63,281	55,264	47,454
Occupancy	8,791	7,723	6,528
Equipment rent, depreciation and maintenance	5,494	4,847	4,544
Other	<u>20,221</u>	<u>19,118</u>	<u>18,012</u>
Total noninterest expense	<u>97,787</u>	<u>86,952</u>	<u>76,538</u>
Income before income taxes and minority interest	40,350	38,200	26,362
Income taxes—Note L	<u>14,699</u>	<u>14,035</u>	<u>9,314</u>
Income before minority interest	25,651	24,165	17,048
Minority interest in net losses (income) of consolidated subsidiaries	<u>1,065</u>	<u>(785)</u>	<u>(395)</u>
NET INCOME	<u>\$ 26,716</u>	<u>\$ 23,380</u>	<u>\$ 16,653</u>
NET INCOME PER SHARE—Note M:			
Basic	<u>\$ 1.88</u>	<u>\$ 1.86</u>	<u>\$ 1.64</u>
Diluted	<u>\$ 1.79</u>	<u>\$ 1.77</u>	<u>\$ 1.57</u>

See notes to consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity (in \$1,000s, except share and per-share data)

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Compensation Regarding Restricted Stock and Other	Total
Balances at January 1, 2002	\$ 67,692	\$ 14,173	\$ 158	\$ (1,851)	\$ 80,172
Issuance of 3,606,306 shares of common stock to acquire minority interests of subsidiaries	64,801				64,801
Issuance of 193,306 shares of common stock upon exercise of stock options and warrants	2,301				2,301
Issuance of 34,622 shares of common stock in exchange for investment security	440				440
Allocation of shares to ESOP participants' accounts				145	145
Cash dividends paid (\$.44 per share)		(4,508)			(4,508)
Components of comprehensive income:					
Net income for 2002		16,653			16,653
Market value adjustment for investment securities available for sale (net of income tax effect)			33		33
Comprehensive income for 2002					<u>16,686</u>
BALANCES AT DECEMBER 31, 2002	135,234	26,318	191	(1,706)	160,037
Issuance of 1,327,378 shares of common stock to acquire minority interests in bank subsidiaries	29,134				29,134
Issuance of 280,842 shares of common stock upon exercise of stock options, net of common stock surrendered to facilitate exercise, and exercise of 22,512 warrants	2,287				2,287
Private placement of 549,000 shares of common stock	10,226				10,226
Surrender and cancellation of 74,179 shares of common stock in repayment of note receivable from exercise of stock options	(1,561)			1,561	--
Issuance of 259,017 shares of restricted common stock	5,637			(5,637)	--
Recognition of compensation expense relating to restricted common stock				642	642
Allocation of shares to ESOP participants' accounts				145	145
Cash dividends paid (\$.51 per share)		(6,563)			(6,563)
Components of comprehensive income:					
Net income for 2003		23,380			23,380
Market value adjustment for investment securities available for sale (net of income tax effect)			(391)		(391)
Comprehensive income for 2003					<u>22,989</u>
BALANCES AT DECEMBER 31, 2003	180,957	43,135	(200)	(4,995)	218,897
Issuance of 183,349 shares of common stock in conjunction with acquisition of First Carolina State Bank	4,970				4,970
Issuance of 346,947 shares of common stock to acquire minority interest in subsidiaries	8,665				8,665
Issuance of 257,409 shares of common stock upon exercise of stock options, net of common stock surrendered to facilitate exercise	1,302				1,302
Issuance of 13,063 shares of restricted common stock	377			(377)	--
Recognition of compensation expense relating to restricted common stock of \$1,168 and other				820	820
Cash dividends paid (\$.65 per share)		(9,375)			(9,375)
Components of comprehensive income:					
Net income for 2004		26,716			26,716
Market value adjustment for investment securities available for sale (net of income tax effect)			164		164
Comprehensive income for 2004					<u>26,880</u>
BALANCES AT DECEMBER 31, 2004	\$ 196,271	\$ 60,476	\$ (36)	\$ (4,552)	\$ 252,159

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

	- Year Ended December 31 -		
	2004	2003	2002
		(in \$1,000s)	
OPERATING ACTIVITIES			
Net income	\$ 26,716	\$ 23,380	\$ 16,653
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	12,708	9,861	12,676
Depreciation of premises and equipment	4,881	4,102	3,451
Amortization of intangibles	549	532	399
Net amortization (accretion) of investment security premiums (discounts)	87	74	(22)
Loss (gain) on sales of premises and equipment	111	(83)	64
Minority interest in net losses (income) of consolidated subsidiaries	(1,065)	785	395
Compensation expense relating to restricted common stock	1,168	642	
Deferred income taxes	(2,282)	325	(2,224)
Originations and purchases of loans held for resale	(715,238)	(1,261,078)	(891,498)
Proceeds from sales of loans held for resale	715,096	1,293,497	878,565
Increase in accrued interest income and other assets	(5,475)	(232)	(2,187)
Increase (decrease) in accrued interest expense on deposits and other liabilities	<u>347</u>	<u>783</u>	<u>(62)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	37,603	72,588	16,210
INVESTING ACTIVITIES			
Cash and cash equivalents of acquired subsidiary	4,202		
Proceeds from sales of investment securities available for sale	59,574	25,451	8,672
Proceeds from calls, prepayments and maturities of investment securities	18,254	16,786	67,938
Purchases of investment securities	(19,736)	(101,971)	(66,989)
Net increase in portfolio loans	(403,358)	(263,478)	(263,744)
Proceeds from sales of premises and equipment	23	1,733	60
Purchases of premises and equipment	<u>(11,139)</u>	<u>(8,808)</u>	<u>(8,871)</u>
NET CASH USED BY INVESTING ACTIVITIES	(352,180)	(330,287)	(262,934)
FINANCING ACTIVITIES			
Net increase in demand deposits, NOW accounts and savings accounts	151,512	223,164	271,571
Net increase in certificates of deposit	16,354	3,428	50,116
Net borrowings from (payments on) debt obligations	77,900	(624)	3,487
Net proceeds from issuance of subordinated debentures	9,935	39,160	2,899
Resources provided by minority interest	14,778	19,559	8,351
Net proceeds from issuance of common stock	954	12,014	2,301
Cash dividends paid	<u>(9,375)</u>	<u>(6,563)</u>	<u>(4,508)</u>
NET CASH PROVIDED BY FINANCING ACTIVITIES	262,058	290,138	334,217
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(52,519)	32,439	87,493
Cash and cash equivalents at beginning of year	<u>283,623</u>	<u>251,184</u>	<u>163,691</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 231,104</u>	<u>\$ 283,623</u>	<u>\$ 251,184</u>

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE A—NATURE OF OPERATIONS, BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION

Capitol Bancorp Limited (“Capitol” or the “Corporation”) is a multibank holding company. Consolidated bank subsidiaries consist of the following:

Affiliate	Location	Percentage Owned at December 31, 2004	Year Formed or Acquired
<i>Eastern Regions</i>			
Great Lakes Region Banks:			
Ann Arbor Commerce Bank	Ann Arbor, Michigan	100%	1990
Brighton Commerce Bank	Brighton, Michigan	100%	1997
Capitol National Bank	Lansing, Michigan	100%	1982
Detroit Commerce Bank	Detroit, Michigan	100%	1998
Elkhart Community Bank	Elkhart, Indiana	100%	1999
Goshen Community Bank	Goshen, Indiana	100%	2000
Grand Haven Bank	Grand Haven, Michigan	100%	1995
Kent Commerce Bank	Grand Rapids, Michigan	100%	1998
Macomb Community Bank	Clinton Township, Michigan	100%	1996
Muskegon Commerce Bank	Muskegon, Michigan	100%	1997
Oakland Commerce Bank	Farmington Hills, Michigan	100%	1992
Paragon Bank & Trust	Holland, Michigan	100%	1994
Portage Commerce Bank	Portage, Michigan	100%	1988
First Carolina State Bank	Rocky Mount, North Carolina	100%	2004
<i>Western Regions</i>			
Southwest Region Banks:			
Arrowhead Community Bank	Glendale, Arizona	100%	2000
Bank of Las Vegas	Las Vegas, Nevada	51%	2002
Bank of Tucson	Tucson, Arizona	100%	1996
Black Mountain Community Bank	Henderson, Nevada	100%	2000
Camelback Community Bank	Phoenix, Arizona	100%	1998
Desert Community Bank	Las Vegas, Nevada	100%	1999
East Valley Community Bank	Chandler, Arizona	100%	1999
Mesa Bank	Mesa, Arizona	100%	1998
Red Rock Community Bank	Las Vegas, Nevada	100%	1999
Southern Arizona Community Bank	Tucson, Arizona	100%	1998
Sunrise Bank of Albuquerque	Albuquerque, New Mexico	100%	2000
Sunrise Bank of Arizona	Phoenix, Arizona	100%	1998
Valley First Community Bank	Scottsdale, Arizona	100%	1997
Yuma Community Bank	Yuma, Arizona	100%	2000
California Region Banks:			
Bank of Escondido	Escondido, California	26%	2003
Napa Community Bank	Napa, California	51%	2002
Point Loma Community Bank	Point Loma, California	26%	2004
Sunrise Bank of San Diego	San Diego, California	100%	2001

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE A—NATURE OF OPERATIONS, BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION—Continued

At December 31, 2004, Capitol owned a majority interest in one bank holding company subsidiary, First California Southern Bancorp, which had two majority-owned bank subsidiaries, Bank of Escondido and Point Loma Community Bank.

In late 2003, Capitol formed a new bank-development subsidiary, Capitol Development Bancorp Limited I (“CDBLI”). In early 2004, a second bank-development subsidiary was formed, Capitol Development Bancorp Limited II (“CDBLII”). Both CDBLI and CDBLII were each capitalized with two classes of common stock, voting and nonvoting. All of the voting common stock (an aggregate investment of \$1 million for each entity) is owned by Capitol. All of the nonvoting common stock (an aggregate investment of approximately \$10.9 million as to CDBLI and \$9.9 million as to CDBLII) was sold in private offerings to accredited investors, some of whom are related parties of Capitol. CDBLI and CDBLII will be engaged in bank development activities, either on a *de novo* basis or through acquisition opportunities. CDBLI and CDBLII were inactive at December 31, 2004 and have been included as consolidated subsidiaries of Capitol. CDBLI acquired a controlling interest in its first *de novo* bank subsidiary in early January 2005.

Capitol views itself as a bank-development company. It is engaged in the formation of *de novo* banks through majority ownership made directly by Capitol, or through a subsidiary bank-development company, with the remainder of a bank’s start-up capital provided by local investors in the community of that bank. When a *de novo* bank reaches a point of development near its third year of operation, Capitol has typically offered the bank’s minority shareholders an opportunity to exchange their bank shares for shares of Capitol. Capitol has made similar exchange proposals regarding the minority interests of some of its bank-development-company subsidiaries. In each instance, however, Capitol is under no obligation to offer such a share exchange and such share exchange proposals are generally subject to approval by the minority shareholders in each proposed transaction. Capitol also pursues bank development activities through exploring acquisition opportunities.

Capitol and its subsidiaries are engaged in a single business activity--banking. The bank affiliates provide a full range of banking services to individuals, businesses and other customers located in the respective communities of the banks’ domicile. Most of the banks operate from a single location and all are commercially-focused (as contrasted to retail or transaction-oriented banks) on meeting the various credit and other banking needs of entrepreneurs, professionals and other businesses and individuals. A variety of deposit products are offered, including checking, savings, money market, individual retirement accounts and certificates of deposit. In addition, trust and investment services are offered through Paragon Bank & Trust. The principal markets for the banks' financial services are

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE A—NATURE OF OPERATIONS, BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION—Continued

the communities in which the banks are located and the areas immediately surrounding those communities. In addition to commercial banking units, mortgage banking activities are offered through Amera Mortgage Corporation, a less than 50%-owned affiliate, which is accounted for under the equity method.

Each bank is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the banks operate independently and are managed and monitored separately, each bank is substantially similar in terms of business focus, type of customers, products and services. Further, each of the banks and the Corporation are subject to substantially similar laws and regulations unique to the banking industry. Accordingly, the Corporation's consolidated financial statements reflect the presentation of segment information on an aggregated basis.

The consolidated financial statements include the accounts of the Corporation and its majority-owned subsidiaries, after elimination of intercompany accounts and transactions, and after giving effect to applicable minority interests. Banks formed or acquired during 2002, 2003 and 2004 are included in the consolidated financial statements for periods after joining the consolidated group. Certain 2003 and 2002 amounts have been reclassified to conform to the 2004 presentation.

NOTE B—SIGNIFICANT ACCOUNTING POLICIES

Estimates: The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results will differ from those estimates because of the inherent subjectivity and inaccuracy of any estimation.

Cash and Cash Equivalents: Cash and cash equivalents include cash on hand, amounts due from banks (interest-bearing and noninterest-bearing), money-market funds and federal funds sold. Generally, federal funds transactions are entered into for a one-day period.

Loans Held For Resale: Loans held for resale represent residential real estate mortgage loans held for sale into the secondary market. Loans held for resale are stated at the aggregate lower of cost or market. Fees from the origination of loans held for resale are recognized in the period the loans are originated.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

Investment Securities: Investment securities available for sale (generally most debt investment securities of Capitol's banks) are carried at market value with unrealized gains and losses reported as a separate component of stockholders' equity, net of tax effect (accumulated other comprehensive income). All other investment securities are classified as held for long-term investment and are carried at amortized cost which approximates market value (see Note C).

Investments are classified at the date of purchase based on management's analysis of liquidity and other factors. The adjusted cost of the specific securities sold is used to compute realized gains or losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Loans, Credit Risk and Allowance for Loan Losses: Portfolio loans are carried at their principal balance based on management's intent and ability to hold such loans for the foreseeable future until maturity or repayment.

Credit risk arises from making loans and loan commitments in the ordinary course of business. Substantially all portfolio loans are made to borrowers in the banks' geographic areas. Consistent with the banks' emphasis on business lending, there are concentrations of credit in loans secured by commercial real estate, equipment and other business assets. The maximum potential credit risk to Capitol, without regard to underlying collateral and guarantees, is the total of loans and loan commitments outstanding. Management reduces Capitol's exposure to losses from credit risk by requiring collateral and/or guarantees for loans granted and by monitoring concentrations of credit, in addition to recording provisions for loan losses and maintaining an allowance for loan losses.

The allowance for loan losses is maintained at a level believed adequate by management to absorb estimated losses inherent in the portfolio at the balance sheet date. Management's determination of the adequacy of the allowance is an estimate based on evaluation of the portfolio (including potential impairment of individual loans and concentrations of credit), past loss experience, current economic conditions, volume, amount and composition of the loan portfolio, loan commitments outstanding and other factors. The allowance is increased by provisions charged to operations and reduced by net charge-offs.

Capitol has stand-by letters of credit outstanding that, when issued, commit the banks to make payments on behalf of customers if certain specified future events occur, generally being non-payment by the customer. They generally expire within one year and require collateral and/or personal guarantees based on management's credit assessment. The maximum credit risk

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

associated with these instruments equals their contractual amounts, assuming that the counterparty defaults and the collateral proves to be worthless. The total contractual amounts do not necessarily represent future cash requirements since many of these guarantees may expire without being drawn upon. Capitol records a liability, generally equal to the fees received, for these stand-by letters of credit.

Interest and Fees on Loans: Interest income on loans is recognized based upon the principal balance of loans outstanding. Fees from origination of portfolio loans generally approximate the direct costs of successful loan originations.

The accrual of interest is generally discontinued when a loan becomes 90 days past due as to interest. When interest accruals are discontinued, interest previously accrued (but unpaid) is reversed. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to cover the principal balance and accrued interest and the loan is in process of collection.

Interest Expense: For the periods presented, interest paid on all debt obligations approximates amounts charged to expense.

Premises and Equipment: Premises and equipment are stated on the basis of cost. Depreciation, which relates primarily to equipment and furniture with estimated useful lives of approximately three to seven years, is computed principally by the straight-line method. Buildings are generally depreciated on a straight-line basis with estimated useful lives of approximately 40 years. Leasehold improvements are generally depreciated over the respective lease term.

Goodwill and Other Intangibles: Goodwill is reviewed periodically by management for impairment and, accordingly, impairment adjustments of goodwill are charged against earnings, when determined. Other intangibles, which generally consist of core deposit intangibles, are amortized over varying periods of less than 10 years and are not material.

Other Real Estate: Other real estate (included as a component of other assets, and at December 31, 2004 and 2003 approximated \$3,855,000 and \$4,248,000, respectively) comprises properties acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure. These properties held for sale are carried at the lower of cost or estimated fair value (net of estimated selling cost) at the date acquired and are periodically reviewed for subsequent impairment.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

Stock-Based Compensation: No stock-based compensation expense is recorded upon granting of stock options because such stock options are accounted for under the provisions of Accounting Principles Board (APB) Opinion 25 (and related interpretations) and are granted at an exercise price equal to the market price of common stock at grant date. Compensation expense for awards of restricted stock is recognized ratably over the vesting periods of such awards (generally four years), based on the fair value of the common stock on the date of grant.

Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, establishes an alternative fair value method of accounting for stock options whereby compensation expense would be recognized based on the computed fair value of the options on the grant date. By not electing this alternative, certain pro forma disclosures of the expense recognition provisions of Statement No. 123 are required, which are as follows:

	2004	2003	2002
Fair value assumptions:			
Risk-free interest rate	3.9%	3.6%	4.5%
Dividend yield	2.3%	2.1%	2.5%
Stock price volatility	.25	.44	.46
Expected option life	6.7 years	7 years	7 years
Aggregate estimated fair value of options granted (in thousands)	\$ 6,581	\$ 6,117	\$11,548
Net income (in thousands):			
As reported	26,716	23,380	16,653
Pro forma	22,438	19,404	8,078
Net income per share:			
Basic:			
As reported	1.88	1.86	1.64
Pro forma	1.58	1.54	0.80
Diluted:			
As reported	1.79	1.77	1.57
Pro forma	\$ 1.51	\$ 1.47	\$ 0.76

Accounting for stock options will change in 2005, upon implementation of new accounting guidance which will require compensation expense recognition for stock options when granted (see subsequent disclosures in this Note B under the caption, “New Accounting Standards”).

Trust Assets and Related Income: Customer property, other than funds on deposit, held in a fiduciary or agency capacity by Capitol's banks is not included in the consolidated balance sheet because it is not an asset of the banks or Capitol. Trust fee income is recorded on the accrual method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

Federal Income Taxes: Capitol and subsidiaries owned 80% or more by Capitol file a consolidated federal income tax return. Deferred federal income taxes are recognized for the tax consequences of temporary differences by applying enacted tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred income taxes of a change in tax laws or rates is recognized in income in the period that includes the enactment date.

Comprehensive Income: Comprehensive income is the sum of net income and certain other items which are charged or credited to stockholders' equity. For the periods presented, Capitol's only element of comprehensive income other than net income was the net change in the market value adjustment for investment securities available for sale. Accordingly, the elements and total of comprehensive income are shown within the statement of changes in stockholders' equity presented herein.

New Accounting Standards: Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, clarifies how some instruments or securities should be classified on an issuer's balance sheet and their related impact on income and results of operations. As it applies to financial instruments that were within its scope, the Statement was effective for Capitol's consolidated financial statements beginning July 1, 2003. Implementation of this standard resulted in the reclassification of Capitol's trust-preferred securities from their prior "mezzanine" classification (between liabilities and equity) to part of debt obligations on Capitol's consolidated balance sheet. Such securities continue to be treated as an element of capital for regulatory purposes. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, (as revised December 2003--FIN 46(R)), clarifies when some entities previously not consolidated under prior accounting guidance, should be. In some instances, it also requires certain previously consolidated entities to be deconsolidated. FIN 46(R) is effective for periods ending after December 15, 2003 for special purpose entities and for periods ending after March 15, 2004 for other types of variable interest entities that are not defined as special purpose entities. Implementation of that new guidance required Capitol to deconsolidate its trusts which issued trust-preferred securities which were classified as debt obligations on Capitol's consolidated balance sheet and then report the underlying subordinated debentures as debt obligations instead of the trust-preferred securities. These standards had no impact on Capitol's results of operations upon implementation.

AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), addresses the accounting for differences between contractual cash flows and cash flows expected to be collected from the initial investment

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

in loans acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and does not apply to loans originated by the entity. The SOP prohibits carrying over or creation of valuation allowances in the initial accounting for loans acquired in a transfer. It is effective for loans acquired in fiscal years beginning after December 15, 2004. The effects of this new guidance on Capitol's consolidated financial statements will depend on future acquisition activity, thus, its impact is not readily determinable.

In December 2004, FASB issued a revision of Statement No. 123. Statement No. 123(R), *Share-Based Payment*, is broader in scope than the original statement, which was more narrowly focused on stock-based compensation, and makes significant changes to accounting for "payments" involving employee compensation and "shares" or securities, in the form of stock options, restricted stock or other arrangements settled in the reporting entity's securities. Most significant in the standard is the requirement that all stock options be measured at estimated fair value at the grant date and recorded as compensation expense over the requisite service period associated with the option, usually the vesting period. The revised standard becomes effective for interim periods beginning after June 30, 2005 and may be applied prospectively to stock options granted after the effective date and any unvested stock options at that date.

Although Capitol's management has not completed its analysis of the revised standard, the effect of the revised standard's implementation will be recognition of compensation expense associated with stock options. Previously, Capitol has used the intrinsic-value method which did not result in expense recognition but, instead, required pro forma presentation of what compensation expense would have been recorded if the fair-value measurement and expense recognition provisions had been applied. Effective December 31, 2004, Capitol accelerated the vesting of all of its outstanding stock options in anticipation of implementation of Statement No. 123(R). Such acceleration of vesting, to make all such stock options vested as of December 31, 2004, was done for the purpose of avoiding future expense associated with any unvested stock options granted prior to the effective date of Statement No. 123(R).

FASB's Emerging Issues Task Force ("EITF"), reached consensus on "*The Meaning of Other-Than-Temporary and Its Application to Certain Investments*" in EITF Issue No. 03-1. The guidance included in the EITF largely consists of expanded disclosures and the guidance was intended to be fully effective in 2003, except for loss-recognition guidance which had a delayed effective date into 2004. In 2004, the FASB has further delayed the loss recognition provisions of Issue No. 03-1, pending additional deliberation in the future. Because of the inconclusive status of the EITF's current position on the loss recognition aspects of Issue No. 03-1, Capitol's management is unable to speculate on the potential impact of this matter on Capitol's consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

A variety of proposed or otherwise potential accounting standards are currently under study by standard-setting organizations and various regulatory agencies. Because of the tentative and preliminary nature of these proposed standards, management has not determined whether implementation of such proposed standards would be material to Capitol's consolidated financial statements.

NOTE C—INVESTMENT SECURITIES

Investment securities consisted of the following at December 31 (in \$1,000s):

	2004		2003	
	Amortized Cost	Estimated Market Value	Amortized Cost	Estimated Market Value
Available for sale:				
United States Treasury securities	\$ 330	\$ 329	\$ 832	\$ 835
United States government agency securities	27,897	27,843	25,431	25,597
Mutual funds	--	--	57,424	56,954
	<u>28,227</u>	<u>28,172</u>	<u>83,687</u>	<u>83,386</u>
Held for long-term investment:				
Federal Reserve Bank stock	535	535	483	483
Federal Home Loan Bank stock	10,878	10,878	6,732	6,732
Corporate stock	1,443	1,443	1,271	1,271
Other	1,335	1,335	1,335	1,335
	<u>14,191</u>	<u>14,191</u>	<u>9,821</u>	<u>9,821</u>
	<u>\$ 42,418</u>	<u>\$ 42,363</u>	<u>\$ 93,508</u>	<u>\$ 93,207</u>

At December 31, 2004, securities with a market value approximating \$13 million were pledged to secure public and trust deposits and for other purposes as required by law. Investments in Federal Reserve Bank stock and Federal Home Loan Bank stock are restricted and may only be resold to, or redeemed by, the issuer.

Gross unrealized gains and losses on investment securities available for sale, which also include unrealized gains/losses on mutual funds, were as follows at December 31 (in \$1,000s):

	2004		2003	
	Gains	Losses	Gains	Losses
United States Treasury securities	\$ --	\$ 1	\$ 3	\$ --
United States government agency securities	110	164	187	21
Mutual funds	--	--	--	470
	<u>\$ 110</u>	<u>\$ 165</u>	<u>\$ 190</u>	<u>\$ 491</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE C—INVESTMENT SECURITIES—Continued

The fair value of securities available for sale with unrealized losses for maturities in excess of one year approximated \$3.1 million (unrealized loss of \$38,000) and the fair value of such securities with maturities of one year or less approximated \$17.6 million (unrealized loss of \$127,000). Management does not believe any individual unrealized loss as of December 31, 2004 represents other-than-temporary losses and has both the intent and ability to hold these securities for a time period necessary to recover the amortized cost.

Gross realized gains and losses from sales and maturities of investment securities were insignificant for each of the periods presented.

Scheduled maturities of investment securities held as of December 31, 2004 were as follows (in \$1,000s):

	Amortized Cost	Estimated Market Value
Due in one year or less	\$ 8,331	\$ 8,293
After one year, through five years	11,797	11,728
After five years, through ten years	2,624	2,673
After ten years	5,475	5,478
Securities held for long-term investment, without stated maturities	<u>14,191</u>	<u>14,191</u>
	<u>\$ 42,418</u>	<u>\$ 42,363</u>

NOTE D—LOANS

Portfolio loans consisted of the following at December 31 (in \$1,000s):

	2004	2003
Commercial	\$ 2,444,492	\$ 2,033,097
Real estate mortgage	177,204	143,343
Installment	<u>71,208</u>	<u>71,000</u>
Total portfolio loans	2,692,904	2,247,440
Less allowance for loan losses	<u>(37,572)</u>	<u>(31,404)</u>
Net portfolio loans	<u>\$ 2,655,332</u>	<u>\$ 2,216,036</u>

Transactions in the allowance for loan losses are summarized below (in \$1,000s):

	2004	2003	2002
Balance at January 1	\$ 31,404	\$ 28,953	\$ 23,238
Allowance for loan losses of acquired bank subsidiary	724	--	--
Provision charged to operations	12,708	9,861	12,676
Loans charged off (deduction)	(8,388)	(8,791)	(7,703)
Recoveries	<u>1,124</u>	<u>1,381</u>	<u>742</u>
Net charge-offs	<u>(7,264)</u>	<u>(7,410)</u>	<u>(6,961)</u>
Balance at December 31	<u>\$ 37,572</u>	<u>\$ 31,404</u>	<u>\$ 28,953</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE D—LOANS—Continued

Impaired loans (i.e., loans for which there is a reasonable probability that borrowers would be unable to repay all principal and interest due under the contractual terms of the loan documents) were not material. Nonperforming loans (i.e., loans which are 90 days or more past due and loans on nonaccrual status) are summarized below (in \$1,000s):

	December 31	
	2004	2003
Nonaccrual loans:		
Commercial	\$ 20,618	\$ 19,852
Real estate mortgage	2,396	632
Installment	<u>195</u>	<u>376</u>
Total nonaccrual loans	23,209	20,860
Past due (>90 days) loans:		
Commercial	3,529	4,544
Real estate mortgage	1,382	1,083
Installment	<u>351</u>	<u>385</u>
Total past due loans	<u>5,262</u>	<u>6,012</u>
Total nonperforming loans	<u>\$ 28,471</u>	<u>\$ 26,872</u>

If nonperforming loans had performed in accordance with their contractual terms during the year, additional interest income of \$1,594,000, \$2,046,000 and \$1,514,000 would have been recorded in 2004, 2003 and 2002, respectively. Interest income recognized on loans in nonaccrual status in 2004, 2003 and 2002 operations approximated \$714,000, \$866,000 and \$385,000, respectively. At December 31, 2004, there were no material amounts of loans which were restructured or otherwise renegotiated as a concession to troubled borrowers.

The amounts of the allowance for loan losses allocated in the following table (in \$1,000s) are based on management's estimate of losses inherent in the portfolio at the balance sheet date, and should not be interpreted as an indication of future charge-offs:

	December 31, 2004		December 31, 2003	
	Amount	Percentage of Total Portfolio Loans	Amount	Percentage of Total Portfolio Loans
Commercial	\$ 34,753	1.29%	\$ 29,001	1.29%
Real estate mortgage	1,808	0.07	1,408	0.06
Installment	<u>1,011</u>	<u>0.04</u>	<u>995</u>	<u>0.05</u>
Total allowance for loan losses	<u>\$ 37,572</u>	<u>1.40%</u>	<u>\$ 31,404</u>	<u>1.40%</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE E—RELATED PARTIES TRANSACTIONS

In the ordinary course of business, Capitol's banking subsidiaries make loans to officers and directors of Capitol and its subsidiaries including their immediate families and companies in which they are principal owners. At December 31, 2004 and 2003, total loans to these persons were \$110 million and \$99 million, respectively. During 2004, \$86 million of new loans were made to these persons and repayments totaled \$75 million. Such loans are made at the banking subsidiaries' normal credit terms.

Officers and directors of Capitol (and their associates, family and/or affiliates) are also depositors of the banking subsidiaries. Such deposits are similarly made at the banks' normal terms as to interest rate, term and deposit insurance.

NOTE F—PREMISES AND EQUIPMENT

Major classes of premises and equipment consisted of the following at December 31 (in \$1,000s):

	<u>2004</u>	<u>2003</u>
Land, buildings and improvements	\$ 14,464	\$ 8,220
Leasehold improvements	11,944	10,066
Equipment and furniture	<u>26,918</u>	<u>23,314</u>
	53,326	41,600
Less accumulated depreciation	<u>(20,665)</u>	<u>(16,807)</u>
	<u>\$ 32,661</u>	<u>\$ 24,793</u>

Capitol and certain subsidiaries rent office space under operating leases. Rent expense (net of sublease income) under these lease agreements approximated \$5,873,000, \$5,313,000 and \$4,394,000 (including rent expense of \$1,637,000, \$1,646,000 and \$1,420,000 under leases with related parties) in 2004, 2003 and 2002, respectively.

At December 31, 2004, future minimum rental payments under operating leases that have initial or remaining noncancelable lease terms in excess of one year were as follows (in \$1,000s):

2005	\$ 5,783
2006	5,966
2007	5,309
2008	4,544
2009	3,688
2010 and thereafter	<u>9,783</u>
	<u>\$ 35,073</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE G—DEPOSITS

The aggregate amount of time deposits of \$100,000 or more approximated \$664.8 million and \$584.2 million as of December 31, 2004 and 2003, respectively.

At December 31, 2004, the scheduled maturities of such time deposits were as follows (in \$1,000s):

2005	\$ 526,191
2006	82,437
2007	35,930
2008	10,204
2009 and thereafter	<u>10,084</u>
	<u>\$ 664,846</u>

Interest paid approximates amounts charged to operations on an accrual basis for the periods presented.

NOTE H—NOTES PAYABLE AND SHORT-TERM BORROWINGS

Notes payable and short-term borrowings consisted of the following at December 31 (in \$1,000s):

	<u>2004</u>	<u>2003</u>
Borrowings from Federal Home Loan Bank	\$ 154,135	\$ 92,774
Repurchase agreement	399	--
Federal funds purchased	<u>18,000</u>	<u>--</u>
	<u>\$ 172,534</u>	<u>\$ 92,774</u>

Borrowings from Federal Home Loan Bank (FHLB) represent advances secured by certain portfolio residential real estate mortgage loans and other eligible collateral. Such advances become due at varying dates and bear interest at market short-term rates (approximately 1.51% at December 31, 2004). At December 31, 2004, unused lines of credit under these facilities approximated \$106 million.

Capitol has a credit facility with an unaffiliated bank. Up to \$25 million can be borrowed pursuant to a one-year revolving credit agreement which bears interest at a variable rate (5.00% at December 31, 2004), payable monthly, and a quarterly facility fee on the unused portion. There were no amounts drawn on the line of credit at December 31, 2004. The credit facility is reviewed annually for continuance and requires Capitol, among other things, to maintain certain minimum levels of capital, rates of return on assets and other ratios or requirements, and is secured by the common stock of certain bank subsidiaries.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE H—NOTES PAYABLE AND SHORT-TERM BORROWINGS—Continued

At December 31, 2004, scheduled debt maturities of notes payable and short-term borrowings were as follows (in \$1,000s):

2005	\$ 85,073
2006	33,321
2007	18,000
2008	--
2009 and thereafter	<u>36,140</u>
	<u>\$ 172,534</u>

In addition to the foregoing, Capitol has guaranteed some obligations of its subsidiaries (see Note O).

NOTE I—SUBORDINATED DEBT

Subordinated debt relates to trust-preferred securities issued by Capitol which are summarized as follows:

Description	Interest Rate at December 31, 2004	Scheduled Maturity	Aggregate Liquidation Amount (in \$1,000s)	Net Carrying Amount at December 31 (in \$1,000s)	
				2004	2003
Capitol Trust I	8.50% fixed	2027	\$ 25,300	\$ 24,471	\$ 24,435
Capitol Trust II	10.25% fixed	2031	10,000	9,733	9,723
Capitol Statutory Trust III	5.74% variable	2031	15,000	14,600	14,585
Capitol Trust IV	5.72% variable	2032	3,000	2,908	2,904
Capitol Trust VI	5.37% variable	2033	10,000	9,717	9,707
Capitol Trust VII	7.78% fixed	2033	10,000	9,856	9,851
Capitol Statutory Trust VIII	5.45% variable	2033	20,000	19,624	19,611
Capitol Trust IX	7.69% variable	2034	<u>10,000</u>	<u>9,936</u>	
			<u>\$103,300</u>	<u>\$100,845</u>	<u>\$ 90,816</u>

Securities of Capitol Trust I were issued in a 1997 public offering. Capitol Trust II and Capitol Statutory Trust III were formed in 2001 in conjunction with private placements of pooled trust-preferred securities. Capitol Trust IV was formed in 2002, Capitol Trust VI, Capitol Trust VII and Capitol Statutory Trust VIII were formed in 2003 and Capitol Trust IX was formed in 2004. Each of these securities have similar terms and, subject to certain provisions, may be called by the issuer five years after issuance. The liquidation amount of these securities is guaranteed by Capitol.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE I—SUBORDINATED DEBT—Continued

Interest paid to the Trusts by Capitol (which is recorded as interest expense in its consolidated financial statements) is distributed by the Trusts to the holders of the trust-preferred securities. Under certain conditions, Capitol may defer payment of interest on the subordinated debentures for periods of up to five years. Under current regulatory guidelines, such trust-preferred securities are included as capital for purposes of meeting certain ratio requirements.

NOTE J—RESTRICTED COMMON STOCK AND STOCK OPTIONS

Restricted common stock has been granted to certain officers. Compensation expense relating to the award of restricted stock is recognized ratably over the vesting periods of such awards (generally four years). The weighted-average grant-date fair value of restricted stock awards in 2004 was \$28.86 per share. Compensation expense related to restricted stock in 2004 and 2003 approximated \$1,168,000 and \$642,000, respectively (none in 2002).

Stock options have been granted to certain officers and directors which provide for the purchase of shares of common stock. Generally, stock options are granted at an exercise price equal to the fair value of common stock on the grant date. All such stock options expire at varying periods up to seven years after the date granted. Stock option activity is summarized as follows:

	Number of Stock Options Outstanding	Exercise Price Range		Weighted Average Exercise Price	
Outstanding at January 1, 2002	1,203,123	\$ 4.92	to	\$25.10	\$ 12.46
Granted in 2002	1,669,004	13.50	to	23.24	16.39
Exercised in 2002	(138,447)	8.17	to	16.17	9.68
Cancelled or expired in 2002	(185,144)				
Outstanding at December 31, 2002	<u>2,548,536</u>	4.92	to	25.10	15.23
Granted in 2003	577,200	20.36	to	27.23	24.45
Exercised in 2003	(801,448)	4.92	to	25.92	14.41
Cancelled or expired in 2003	(26,221)				
Outstanding at December 31, 2003	<u>2,298,067</u>	9.88	to	27.23	16.95
Granted in 2004	834,647	22.43	to	33.01	27.77
Exercised in 2004	(515,836)	9.88	to	25.92	15.93
Cancelled or expired in 2004	(32,739)				
Outstanding at December 31, 2004	<u>2,584,139</u>	\$10.81	to	\$33.01	<u>\$ 21.06</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE J—RESTRICTED COMMON STOCK AND STOCK OPTIONS—Continued

At December 31, 2004, all outstanding stock options are currently exercisable. Effective December 31, 2004, the vesting of any previously unvested stock options was accelerated in anticipation of implementation of a new accounting standard (see Note B). As of December 31, 2004, stock options outstanding had a weighted average remaining contractual life of 4.3 years. The following table summarizes stock options outstanding segregated by exercise price range:

Exercise Price Range	Number Outstanding	Weighted Average	
		Exercise Price	Remaining Contractual Life
\$10.00 to 14.99	346,088	\$11.32	2.5 years
\$15.00 to 19.99	769,986	16.59	3.6 years
\$20.00 to 24.99	553,038	21.80	3.6 years
\$25.00 to 29.99	755,455	27.01	6.0 years
\$30.00 or more	159,572	\$32.98	5.7 years
	<u>2,584,139</u>		

NOTE K—EMPLOYEE RETIREMENT PLANS

Capitol has a contributory employee retirement savings 401(k) plan which covers substantially all full-time employees of Capitol and certain subsidiaries over age 21. The Plan provides for employer contributions in amounts determined annually by Capitol's board of directors. Eligible employees make voluntary contributions to the Plan. Employer contributions to the Plan, which are a match for employee contributions (50%, subject to certain limitations), charged to expense for the years ended December 31, 2004, 2003 and 2002 were \$1,027,000, \$918,000 and \$717,000, respectively.

Capitol also has a defined contribution employee stock ownership plan (ESOP) which covers substantially all employees of Capitol and certain subsidiaries. Certain common stock purchases by the ESOP were financed by long-term debt. ESOP contributions charged to expense in 2004, 2003 and 2002 approximated \$961,000, \$642,000 and \$405,000, respectively (including ESOP note payable interest of \$12,000 in 2003 and \$24,000 in 2002; none in 2004). Certain shares of common stock held by the ESOP which were not allocated to participants' accounts were shown as a reduction of stockholders' equity through interim periods in 2003. As of December 31, 2004, the ESOP held approximately 265,000 shares of Capitol's common stock which have been allocated to participants' accounts; there were no unallocated shares as of that date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE L—INCOME TAXES

Income taxes include the following components (in \$1,000s):

	2004	2003	2002
Federal current	\$ 15,401	\$ 12,549	\$ 10,925
Federal deferred expense (credit)	(2,282)	325	(2,224)
State income taxes	<u>1,580</u>	<u>1,161</u>	<u>613</u>
	<u>\$ 14,699</u>	<u>\$ 14,035</u>	<u>\$ 9,314</u>

Deferred state income taxes were insignificant for the periods presented. In addition to state income taxes, certain states in which the banks operate impose taxes based on measures other than income. Tax expense incurred associated with those jurisdictions approximated \$1,010,000, \$909,000 and \$713,000 in 2004, 2003 and 2002, respectively, and are excluded from income tax expense and included in other noninterest expense.

Federal income taxes paid in 2004, 2003 and 2002 approximated \$17.1 million, \$9.7 million and \$11.9 million, respectively. State income taxes paid approximated \$1.6 million in 2004 (\$867,000 in 2003 and \$771,000 in 2002).

Differences between income tax expense recorded and amounts computed using the statutory tax rate are reconciled below (in \$1,000s):

	2004	2003	2002
Federal income tax computed at statutory rate of 35%	\$ 14,122	\$ 13,370	\$ 9,227
State income taxes	1,580	1,161	613
Federal tax effect of:			
Amortization of goodwill and other intangibles	192	186	139
State income taxes	(553)	(406)	(214)
Adjustment of deferred income taxes to effective tax rate of 35%			(221)
Other	<u>(642)</u>	<u>(276)</u>	<u>(230)</u>
	<u>\$ 14,699</u>	<u>\$ 14,035</u>	<u>\$ 9,314</u>

Net deferred income tax assets consisted of the following at December 31 (in \$1,000s):

	2004	2003
Allowance for loan losses	\$ 11,596	\$ 9,493
Net operating losses of subsidiaries	1,683	745
Deferred compensation	2,224	1,515
Market value adjustment for investment securities available for sale	3	102
Other, net	<u>(1,358)</u>	<u>(408)</u>
	<u>\$ 14,148</u>	<u>\$ 11,447</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE L—INCOME TAXES—Continued

Certain consolidated subsidiaries have net operating loss carryforwards which may reduce income taxes payable in future periods. Such carryforwards approximate \$4.8 million at December 31, 2004, have been recognized for financial reporting purposes and expire at the following dates and amounts (in \$1,000s):

2022	\$ 393,000
2023	1,030,000
2024	<u>3,386,000</u>
	<u>\$ 4,809,000</u>

NOTE M—NET INCOME PER SHARE

The computations of basic and diluted net income per share were as follows (in 1,000s):

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Numerator--net income	<u>\$ 26,716</u>	<u>\$ 23,380</u>	<u>\$ 16,653</u>
Denominator:			
Weighted average number of shares outstanding, excluding unvested restricted shares (denominator for basic earnings per share)	14,183	12,602	10,139
Effect of dilutive securities:			
Unvested restricted shares	263	157	
Warrants			12
Stock options	<u>445</u>	<u>416</u>	<u>449</u>
Potential dilution	<u>708</u>	<u>573</u>	<u>461</u>
Denominator for diluted earnings per share—weighted average number of shares and potential dilution	<u>14,891</u>	<u>13,175</u>	<u>10,600</u>
Number of antidilutive stock options excluded from diluted earnings per share computation	<u>160</u>	<u>337</u>	<u>243</u>

Additional disclosures regarding restricted shares and stock options are set forth in Note J.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE N—ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

Carrying values and estimated fair values of financial instruments were as follows at December 31 (in \$1,000s):

	2004		2003	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 231,104	\$ 231,104	\$ 283,623	\$ 283,623
Loans held for resale	43,143	43,143	43,001	43,001
Investment securities:				
Available for sale	28,172	28,172	83,386	83,386
Held for long-term investment	<u>14,191</u>	<u>14,191</u>	<u>9,821</u>	<u>9,821</u>
	42,363	42,363	93,207	93,207
Portfolio loans:				
Commercial	2,444,492	2,444,379	2,033,097	2,042,269
Real estate mortgage	177,204	177,697	143,343	152,444
Installment	<u>71,208</u>	<u>71,833</u>	<u>71,000</u>	<u>70,919</u>
Total portfolio loans	2,692,904	2,693,909	2,247,440	2,265,632
Less allowance for loan losses	<u>(37,572)</u>	<u>(37,572)</u>	<u>(31,404)</u>	<u>(31,404)</u>
Net portfolio loans	2,655,332	2,656,337	2,216,036	2,234,228
Financial Liabilities:				
Deposits:				
Noninterest-bearing				
	503,902	503,902	435,599	435,599
Interest-bearing:				
Demand accounts				
	1,041,796	1,027,417	971,879	973,042
Time certificates of less than \$100,000				
	299,528	301,347	296,992	293,897
Time certificates of \$100,000 or more				
	<u>664,846</u>	<u>668,310</u>	<u>584,194</u>	<u>590,374</u>
Total interest-bearing	<u>2,006,170</u>	<u>1,997,074</u>	<u>1,853,065</u>	<u>1,857,313</u>
Total deposits	2,510,072	2,500,976	2,288,664	2,292,912
Notes payable and short-term borrowings				
	172,534	173,305	92,774	92,867
Subordinated debentures	100,845	103,300	90,816	93,300

Estimated fair values of financial assets and liabilities are based upon a comparison of current interest rates on financial instruments and the timing of related scheduled cash flows to the estimated present value of such cash flows using current estimated market rates of interest (unless quoted market values or other fair value information is more readily available). Such estimates of fair value are not intended to represent market value or portfolio liquidation value, and only represent an estimate of fair values based on current financial reporting requirements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE O—COMMITMENTS, GUARANTEES AND OTHER CONTINGENCIES

In the ordinary course of business, loan commitments are made to accommodate the financial needs of bank customers. Loan commitments include stand-by letters of credit, lines of credit, and other commitments for commercial, installment and mortgage loans. Stand-by letters of credit, when issued, commit the bank to make payments on behalf of customers if certain specified future events occur and are used infrequently by the banks (\$23.3 million and \$25.4 million outstanding at December 31, 2004 and 2003, respectively). Other loan commitments outstanding consist of unused lines of credit and approved, but unfunded, specific loan commitments (\$637.1 million and \$510.9 million at December 31, 2004 and 2003, respectively). These loan commitments (stand-by letters of credit and unfunded loans) generally expire within one year and are reviewed periodically for continuance or renewal.

All loan commitments have credit risk essentially the same as that involved in routinely making loans to customers and are made subject to the banks' normal credit policies. In making these loan commitments, collateral and/or personal guarantees of the borrowers are generally obtained based on management's credit assessment.

The banking subsidiaries are required to maintain average reserve balances in the form of cash on hand and balances due from the Federal Reserve Bank and correspondent banks. The amount of reserve balances required as of December 31, 2004 and 2003 were \$6.1 million and \$4.5 million, respectively.

Deposits at each of the banks are insured up to the maximum amount covered by FDIC insurance. Some of the banks have municipal government deposits which are guaranteed by Capitol (\$17.7 million at December 31, 2004).

Capitol has guaranteed up to \$7.5 million of secured borrowings by Amera Mortgage Corporation, a less than 50%-owned affiliate.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE P—DIVIDEND LIMITATIONS OF SUBSIDIARIES AND OTHER CAPITAL REQUIREMENTS

Current banking regulations restrict the ability to transfer funds from subsidiaries to their parent in the form of cash dividends, loans or advances. Subject to various regulatory capital requirements, bank subsidiaries' current and retained earnings are available for distribution as dividends to Capitol (and other bank shareholders, as applicable) without prior approval from regulatory authorities. Substantially all of the remaining net assets of the subsidiaries are restricted as to payments to Capitol.

Each bank and Capitol are subject to certain other capital requirements. Federal financial institution regulatory agencies have established certain risk-based capital guidelines for banks and bank holding companies. Those guidelines require all banks and bank holding companies to maintain certain minimum ratios and related amounts based on 'Tier 1' and 'Tier 2' capital and 'risk-weighted assets' as defined and periodically prescribed by the respective regulatory agencies. Failure to meet these capital requirements can result in severe regulatory enforcement action or other adverse consequences for a depository institution and, accordingly, could have a material impact on Capitol's consolidated financial statements.

Under the regulatory capital adequacy guidelines and related framework for prompt corrective action, the specific capital requirements involve quantitative measures of assets, liabilities and certain off-balance-sheet items calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgements by regulatory agencies with regard to components, risk weighting and other factors.

As a condition of their charter approval, *de novo* banks are generally required to maintain a core capital (Tier 1) to average assets ratio of not less than 8% (4% for other banks) and an allowance for loan losses of not less than 1% for the first three years of operations.

As of December 31, 2004, the most recent notifications received by the banks from regulatory agencies have advised that the banks are classified as 'well capitalized' as defined by the applicable agencies. There are no conditions or events since those notifications that management believes would change the regulatory classification of the banks.

Management believes, as of December 31, 2004, that Capitol and the banks meet all capital adequacy requirements to which the entities are subject.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE P—DIVIDEND LIMITATIONS OF SUBSIDIARIES AND OTHER CAPITAL REQUIREMENTS—Continued

The following table summarizes the amounts (in \$1,000s) and related ratios of the individually significant subsidiaries (assets of \$200 million or more) and consolidated regulatory capital position as of December 31, 2004 and 2003:

	Ann Arbor Commerce Bank	Capitol National Bank	Consolidated
<u>December 31, 2004</u>			
Tier 1 capital to average adjusted total assets:			
Minimum required amount	≥\$ 13,190	≥\$ 9,165	≥\$121,911
Actual amount	\$ 26,496	\$ 18,007	\$333,049
Ratio	8.03%	7.86%	10.93%
Tier 1 capital to risk-weighted assets:			
Minimum required amount ⁽¹⁾	≥\$ 11,894	≥\$ 7,924	≥\$110,778
Actual amount	\$ 26,496	\$ 18,007	\$333,049
Ratio	8.91%	9.09%	12.03%
Combined Tier 1 and Tier 2 capital to risk-weighted assets:			
Minimum required amount ⁽²⁾	≥\$ 23,788	≥\$ 15,847	≥\$221,555
Amount required to meet 'Well-Capitalized' category ⁽³⁾	\$ 29,735	\$ 19,809	\$276,944
Actual amount	\$ 30,215	\$ 20,486	\$385,273
Ratio	10.16%	10.34%	13.91%
<u>December 31, 2003</u>			
Tier 1 capital to average adjusted total assets:			
Minimum required amount	≥\$ 12,531	≥\$ 8,543	≥\$104,133
Actual amount	\$ 25,262	\$ 16,405	\$287,071
Ratio	8.06%	7.68%	11.03%
Tier 1 capital to risk-weighted assets:			
Minimum required amount ⁽¹⁾	≥\$ 11,502	≥\$ 7,415	≥\$ 93,751
Actual amount	\$ 25,262	\$ 16,405	\$287,071
Ratio	8.79%	8.85%	12.25%
Combined Tier 1 and Tier 2 capital to risk-weighted assets:			
Minimum required amount ⁽²⁾	≥\$ 23,003	≥\$ 14,829	≥\$187,503
Amount required to meet 'Well-Capitalized' category ⁽³⁾	\$ 28,754	\$ 18,537	\$234,379
Actual amount	\$ 28,860	\$ 18,616	\$335,429
Ratio	10.04%	10.04%	14.31%

⁽¹⁾ The minimum required ratio of Tier 1 capital to risk-weighted assets is 4%.

⁽²⁾ The minimum required ratio of Tier 1 and Tier 2 capital to risk-weighted assets is 8%.

⁽³⁾ In order to be classified as a 'well-capitalized' institution, the ratio of Tier 1 and Tier 2 capital to risk-weighted assets must be 10% or more.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE Q—PARENT COMPANY FINANCIAL INFORMATION

Condensed Balance Sheets

	- December 31 -	
	2004	2003
	(in \$1,000s)	
Assets		
Cash on deposit principally with subsidiary banks	\$ 1,618	\$ 2,228
Money market funds on deposit principally with subsidiary banks	8,907	15,194
Time deposits principally with subsidiary banks	21,277	20,116
Investments in and amounts due from subsidiaries	302,628	256,741
Notes receivable, net	1,230	1,556
Investment in and advances to Amera Mortgage Corporation	797	859
Equipment and furniture, net	1,850	1,853
Goodwill and other intangibles	17,209	15,703
Other assets	<u>10,471</u>	<u>7,417</u>
Total assets	<u>\$ 365,987</u>	<u>\$ 321,667</u>
Liabilities and Stockholders' Equity		
Accounts payable, accrued expenses and other liabilities	\$ 9,784	\$ 9,066
Subordinated debentures	<u>104,044</u>	<u>93,704</u>
Total liabilities	113,828	102,770
Stockholders' equity	<u>252,159</u>	<u>218,897</u>
Total liabilities and stockholders' equity	<u>\$ 365,987</u>	<u>\$ 321,667</u>

Condensed Statements Of Income

	- Year Ended December 31 -		
	2004	2003	2002
	(in \$1,000s)		
Income:			
Dividends from subsidiaries	\$ 16,075	\$ 13,675	\$ 10,755
Intercompany fees	16,561	14,752	9,722
Interest	468	118	253
Other	<u>99</u>	<u>2,047</u>	<u>51</u>
Total income	33,203	30,592	20,781
Expenses:			
Interest	6,931	4,874	5,016
Salaries and employee benefits	13,370	11,950	7,662
Occupancy	1,138	963	590
Amortization, equipment rent and depreciation	1,225	1,483	963
Other	<u>5,252</u>	<u>3,131</u>	<u>2,224</u>
Total expenses	<u>27,916</u>	<u>22,401</u>	<u>16,455</u>
Income before equity in undistributed net earnings of consolidated subsidiaries and income tax credit	5,287	8,191	4,326
Equity in undistributed net earnings of consolidated subsidiaries	<u>17,665</u>	<u>13,494</u>	<u>9,861</u>
Income before income tax credit	22,952	21,685	14,187
Income tax credit	<u>(3,764)</u>	<u>(1,695)</u>	<u>(2,466)</u>
Net income	<u>\$ 26,716</u>	<u>\$ 23,380</u>	<u>\$ 16,653</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE Q—PARENT COMPANY FINANCIAL INFORMATION—Continued

Condensed Statements of Cash Flows

	- Year Ended December 31 -		
	2004	2003	2002
		(in \$1,000s)	
OPERATING ACTIVITIES			
Net income	\$ 26,716	\$ 23,380	\$ 16,653
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net earnings of subsidiaries	(17,665)	(13,494)	(9,861)
Depreciation and amortization of intangibles	1,197	996	889
Loss on sale of premises and equipment			50
Decrease in amounts due from subsidiaries and other assets	10,271	31,438	48,978
Increase in accounts payable, accrued expenses and other liabilities	<u>718</u>	<u>2,426</u>	<u>2,908</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	21,237	44,746	59,617
INVESTING ACTIVITIES			
Net cash investments in subsidiaries	(27,887)	(45,396)	(47,543)
Net payments from Amera Mortgage Corporation	62	30	570
Purchases of investment securities			(440)
Proceeds from sales and maturities of securities			838
Proceeds from sales of equipment and furniture			100
Purchases of equipment and furniture	<u>(662)</u>	<u>(977)</u>	<u>(1,318)</u>
NET CASH USED BY INVESTING ACTIVITIES	(28,487)	(46,343)	(47,793)
FINANCING ACTIVITIES			
Net payments on debt obligations		(12,500)	(6,500)
Net proceeds from issuance of common stock	954	12,014	2,301
Net proceeds from issuance of subordinated debentures	9,935	39,160	2,899
Cash dividends paid	<u>(9,375)</u>	<u>(6,563)</u>	<u>(4,508)</u>
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	1,514	32,111	(5,808)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(5,736)	30,514	6,016
Cash and cash equivalents at beginning of year	<u>37,538</u>	<u>7,024</u>	<u>1,008</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 31,802</u>	<u>\$ 37,538</u>	<u>\$ 7,024</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE R—ACQUISITION OF MINORITY INTERESTS AND ACQUISITION OF BANK

During 2004, two share-exchange transactions were completed, whereby certain previously majority-owned consolidated subsidiaries became wholly-owned. These share exchange transactions involved the issuance of previously unissued shares of Capitol's common stock for the minority interests of the following subsidiaries:

<u>Entity</u>	<u>Effective Date</u>	<u>Number of Common Shares Issued</u>
Sunrise Bank of San Diego	May 31, 2004	206,999
First California Northern Bancorp	August 31, 2004	139,948

Had these acquisitions occurred at the beginning of 2004, consolidated net income would have approximated \$26.9 million and diluted earnings per share would have been \$1.79. Each of these acquisitions have been accounted for under the purchase method of accounting. The carrying value of assets and liabilities of the entities closely approximated fair value at the date of the share exchanges. Total consideration for these transactions approximated \$8.7 million which resulted in the recording of goodwill of approximately \$3.7 million and acquisition of minority interests approximating \$3.5 million.

Effective April 1, 2004, Capitol acquired First Carolina State Bank (First Carolina) located in Rocky Mount, North Carolina, in a purchase transaction with total consideration approximating \$10 million. Approximately half of the consideration was paid in cash and the remainder consisted of approximately 183,000 previously unissued shares of Capitol's common stock. At March 31, 2004, First Carolina's total assets approximated \$61.7 million. Capitol's acquisition of First Carolina was accounted for under the purchase-method of accounting and its results of operations are included in Capitol's consolidated financial statements for periods after the effective date of the acquisition. Goodwill of approximately \$4 million was recorded in conjunction with this transaction and will not be amortized, but will be reviewed at least annually for impairment. Had this transaction occurred at the beginning of 2004, net income would have approximated \$26.3 million (\$1.76 per diluted share).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE R—ACQUISITION OF MINORITY INTERESTS AND ACQUISITION OF BANK—Continued

During 2003, several share-exchange transactions were also completed, whereby certain previously majority-owned consolidated subsidiaries similarly became wholly-owned:

<u>Entity</u>	<u>Effective Date</u>	<u>Number of Common Shares Issued</u>
Black Mountain Community Bank	July 31, 2003	223,287
Desert Community Bank	July 31, 2003	209,203
Elkhart Community Bank	July 31, 2003	197,927
Red Rock Community Bank	July 31, 2003	351,778
Arrowhead Community Bank	December 31, 2003	44,452
Goshen Community Bank	December 31, 2003	137,312
Sunrise Bank of Albuquerque	December 31, 2003	43,325
Yuma Community Bank	December 31, 2003	120,094

Had the 2003 acquisitions of minority interests occurred at the beginning of 2003, consolidated net income would have approximated \$24.4 million and diluted earnings per share would have been \$1.73.

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