

FINANCIAL INFORMATION

Table of Contents

Selected Consolidated Financial Data	F-2
Information Regarding Capitol's Common Stock.....	F-3
Chief Executive Officer and Chief Financial Officer Certifications	F-4
Availability of Form 10-K and Certain Other Reports	F-4
Other Corporate and Shareholder Information	F-5
Cautions Regarding Forward-Looking Statements.....	F-6
Management's Discussion and Analysis of Capitol's Business, Financial Condition and Results of Operations:	
Summary and Overview	F-7
Capitol's Bank Development Strategy	F-8
Bank Development as a Defined Focus	F-8
"Incubation" of Young Community Banks.....	F-8
Monitoring and Managing Capitol's Investments in Community Banks.....	F-9
Capitol's Results of Operations.....	F-12
Capitol's Financial Position	F-15
Liquidity, Capital Resources and Capital Adequacy	F-21
Trends Affecting Operations.....	F-25
Critical Accounting Policies Affecting Capitol's Financial Statements	F-29
Use of Estimates in Determining the Allowance for Loan Losses	F-29
Accounting for Goodwill and Other Intangibles	F-30
Accounting for Stock Options	F-30
Consolidation Policy	F-31
New Accounting Standards.....	F-31
Risk Factors Affecting Capitol and its Banks.....	F-31
Report on Management's Assessment of Internal Control Over Financial Reporting.....	F-33
Report of Independent Registered Public Accounting Firm on Management's Assessment of Internal Control Over Financial Reporting.....	F-34
Consolidated Financial Statements:	
Report of Independent Registered Public Accounting Firm.....	F-36
Consolidated Balance Sheets	F-37
Consolidated Statements of Income.....	F-38
Consolidated Statements of Changes in Stockholders' Equity	F-39
Consolidated Statements of Cash Flows.....	F-40
Notes to Consolidated Financial Statements.....	F-41

Selected Consolidated Financial Data

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

	As of and for the Year Ended December 31				
	2006 ⁽¹⁾	2005 ⁽²⁾	2004 ⁽³⁾	2003 ⁽⁴⁾	2002 ⁽⁵⁾
For the year:					
Interest income	\$ 279,353	\$ 224,439	\$ 179,089	\$ 164,416	\$ 156,454
Interest expense	105,586	67,579	47,496	49,490	55,860
Net interest income	173,767	156,860	131,593	114,926	100,594
Provision for loan losses	12,156	10,960	12,708	9,861	12,676
Noninterest income	21,532	21,048	19,252	20,087	14,982
Noninterest expense	137,804	117,289	97,787	86,952	76,538
Net income	42,391	35,925	26,716	23,380	16,653
Net income per share:					
Basic	2.69	2.42	1.88	1.86	1.64
Diluted	2.57	2.34	1.79	1.77	1.57
Cash dividends paid per share	.95	.72	.65	.51	.44
At end of year:					
Total assets	\$ 4,065,816	\$ 3,475,721	\$ 3,091,418	\$ 2,737,062	\$ 2,409,288
Total earning assets	3,743,041	3,204,646	2,885,545	2,521,375	2,226,969
Portfolio loans	3,488,678	2,991,189	2,692,904	2,247,440	1,991,372
Deposits	3,258,485	2,785,259	2,510,072	2,288,664	2,062,072
Notes payable and short-term borrowings	191,154	175,729	172,534	92,774	93,398
Subordinated debentures	101,035	100,940	100,845	90,816	51,583
Minority interests in consolidated subsidiaries	126,512	83,838	39,520	30,946	28,016
Stockholders' equity	361,879	301,866	252,159	218,897	160,037

Quarterly Results of Operations (unaudited)

	Total for the Year	Quarterly Results of Operations (unaudited)			
		Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Year ended December 31, 2006:⁽¹⁾					
Interest income	\$ 279,353	\$ 74,978	\$ 73,082	\$ 68,196	\$ 63,097
Interest expense	105,586	30,896	28,387	24,559	21,744
Net interest income	173,767	44,082	44,695	43,637	41,353
Provision for loan losses	12,156	3,444	3,441	2,815	2,456
Net income	42,391	11,382 ⁽⁶⁾	10,789	10,267	9,953
Net income per share:					
Basic	2.69	.71	.68	.65	.64
Diluted	2.57	.68 ⁽⁶⁾	.66	.63	.61
Cash dividends paid per share	.95	.25	.25	.25	.20
Year ended December 31, 2005:⁽²⁾					
Interest income	\$ 224,439	\$ 61,372	\$ 58,655	\$ 54,491	\$ 49,921
Interest expense	67,579	19,748	17,814	15,899	14,118
Net interest income	156,860	41,624	40,841	38,592	35,803
Provision for loan losses	10,960	3,791	2,107	3,039	2,023
Net income	35,925	10,019	9,594	8,297	8,015
Net income per share:					
Basic	2.42	.66	.64	.56	.55
Diluted	2.34	.64	.61	.54	.52
Cash dividends paid per share	.72	.19	.18	.18	.17

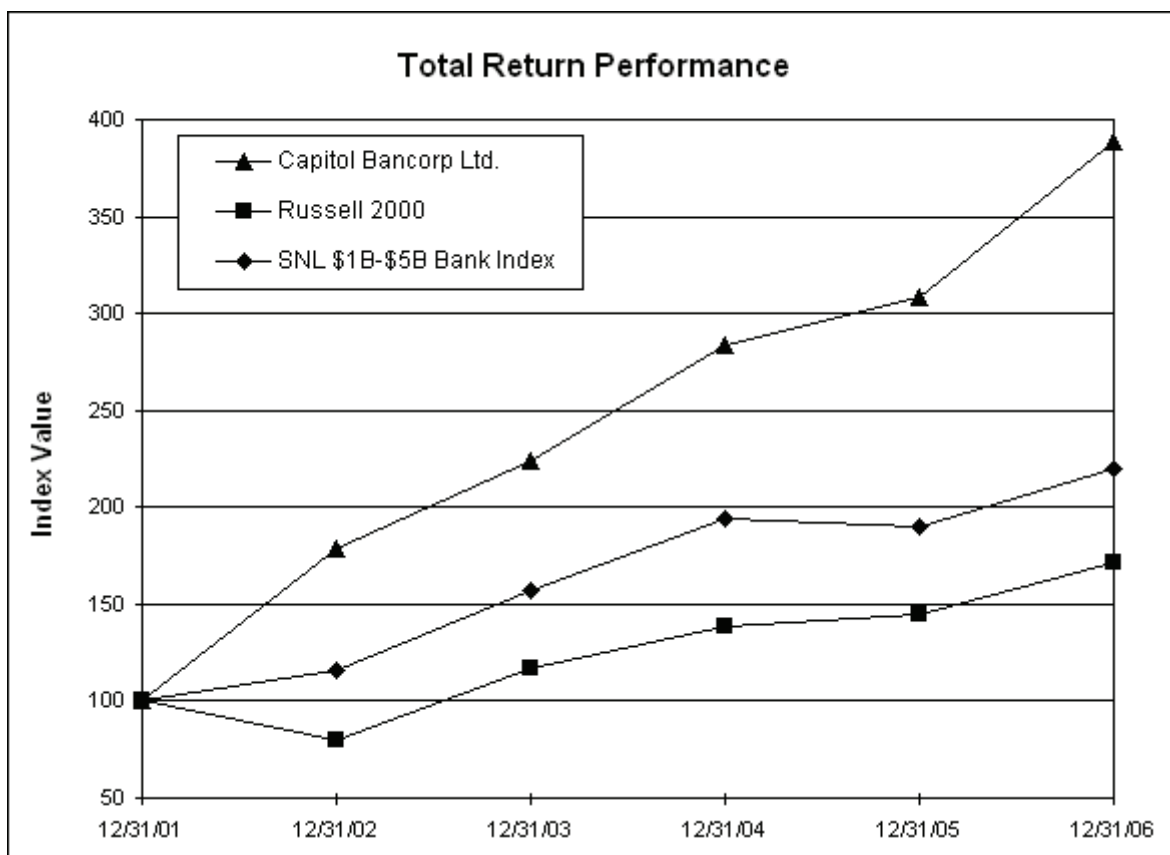
- (1) Includes Community Bank of Rowan, effective February 2006 (located in Salisbury, North Carolina), Asian Bank of Arizona, effective April 2006 (located in Phoenix, Arizona), Evansville Commerce Bank, effective May 2006 (located in Evansville, Indiana), Bank of Valdosta (located in Valdosta, Georgia), Sunrise Bank of Atlanta (located in Atlanta, Georgia) and Bank of Everett (located in Everett, Washington), all effective June 2006, Bank of Maumee (located in Maumee, Ohio) and 1st Commerce Bank (located in North Las Vegas, Nevada), both effective October 2006, and Ohio Commerce Bank (located in Beachwood, Ohio), effective November 2006.
- (2) Includes Bank of Michigan, effective January 2005 (located in Farmington Hills, Michigan), Peoples State Bank, acquired April 7, 2005 (located in Jeffersonville, Georgia), Bank of Bellevue (located in Bellevue, Washington) and Fort Collins Commerce Bank (located in Fort Collins, Colorado), both effective June 2005, Bank of Auburn Hills, effective July 2005 (located in Auburn Hills, Michigan), Bank of San Francisco, effective August 2005 (located in San Francisco, California), Bank of Belleville (located in Belleville, Illinois) and Summit Bank of Kansas City (located in Lee's Summit, Missouri), both effective November 2005, and Bank of Santa Barbara, effective December 2005 (located in Santa Barbara, California).
- (3) 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 2004.
- (4) Includes Bank of Escondido (located in Escondido, California), effective October 2003.
- (5) Includes Bank of Las Vegas (located in Las Vegas, Nevada), effective February 2002 and Napa Community Bank (located in Napa, California), effective March 2002.
- (6) Fourth quarter 2006 net income was favorably impacted by year-end adjustments, primarily driven by loan fees, approximating \$1.3 million (\$0.07 per diluted share) net of income taxes.

INFORMATION REGARDING CAPITOL'S COMMON STOCK

Capitol's common stock is traded on the New York Stock Exchange (NYSE) under the symbol "CBC." Market quotations regarding the range of high and low sales prices of Capitol's common stock, as reported by the NYSE, were as follows:

Quarter Ended:	2006		2005	
	Low	High	Low	High
March 31	\$ 36.74	\$ 47.22	\$ 29.30	\$ 35.82
June 30	37.84	47.16	28.75	34.00
September 30	36.89	46.00	31.25	36.96
December 31	44.12	47.49	29.10	38.93

Below is a graph which summarizes the cumulative return earned by Capitol's shareholders over the last five years compared with the SNL (SNL Financial LC) \$1B-\$5B Asset-Size Index (SNL) and the cumulative total return on the Russell 2000 Index (R-2000). This presentation assumes the value of an investment in Capitol's common stock and each index was \$100 on December 31, 2001 and that subsequent cash dividends were reinvested.



Index	Period Ended					
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
CBC	100.00	178.66	223.47	283.73	308.27	388.96
R-2000	100.00	79.52	117.09	138.55	144.86	171.47
SNL	100.00	115.44	156.98	193.74	190.43	220.36

INFORMATION REGARDING CAPITOL'S COMMON STOCK--Continued

During 2006, Capitol paid cash dividends of \$0.20 per share in the first quarter and \$0.25 per share in the second, third and fourth quarters. In 2005, Capitol paid cash dividends of \$0.17 per share in the first quarter, \$0.18 per share in the second and third quarters and \$0.19 per share in the fourth quarter. 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.

As of January 31, 2007, there were 10,216 beneficial holders of Capitol's common stock, based on information supplied to Capitol from its stock transfer agent and other sources.

At February 26, 2007, 17,046,721 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.

CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER CERTIFICATIONS

Capitol has filed with the U.S. Securities and Exchange Commission all required certifications of its Chief Executive Officer (CEO) and Chief Financial Officer regarding the quality of Capitol's public disclosures. In addition, Capitol's CEO submitted to the NYSE an annual CEO certification stating that he is not aware of any violation by Capitol of the NYSE's corporate governance listing standards.

AVAILABILITY OF FORM 10-K AND CERTAIN OTHER REPORTS

A copy of Capitol's 2006 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.

AVAILABILITY OF FORM 10-K AND CERTAIN OTHER REPORTS--Continued

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

EXECUTIVE OFFICES

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

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 Wednesday, April 25, 2007 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

JP Morgan Institutional Trust Services – Tempe, Arizona

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 Capitol's Business, Financial Condition and Results of Operations

Summary and Overview

This section of the Annual Report is intended to discuss, from management's perspective, matters of importance and relevance to readers regarding Capitol's operations, financial position and other things which have a significant effect on Capitol, its business and its banks. This narrative includes some comments about future events and other forward-looking statements and readers are advised to carefully read the cautionary statement about forward-looking statements which is on page F-6 of this Annual Report.

Capitol is unique in the community banking industry. As a *bank-development company*, Capitol forms new community banks in a wide variety of markets during an era of industry consolidation. Capitol operates in one business segment, community banking. Capitol's banks are staffed with banking professionals, serving customers who desire professional banking services delivered personally.

No other bank holding company in the U.S. is believed to hold as many bank 'charters' (i.e., individually capitalized, licensed and managed, community banks) as distinct operating subsidiaries. Capitol had 50 banks operating in 11 states as of December 31, 2006. Capitol announced plans in 2006 to expand to 100 banks within the next five years.

Capitol's *de novo* bank management model is fine-tuned to create a scalable, low overhead structure which is focused on delivering return-on-equity results, while enabling the individual banks operating autonomy in all areas which impact the customer relationship. Capitol's 'back-office' functions, which support the banks, are capable of expanding coverage in concert with growth in both the number and size of affiliate banks.

2006 was another significant year in Capitol's history:

- Record earnings of \$42 million for the year (\$2.57 per diluted share), an increase of 18% over 2005 earnings of \$36 million (\$2.34 per diluted share).
- Total assets surpassing \$4 billion at year end.
- Substantial growth in the number of banks within Capitol's affiliation network, from 41 at the beginning of the year to 50 at year-end.

In addition to the achievements summarized above, Capitol's management added resources in 2006 in the areas of bank development, risk management, credit administration, technology, and other centralized back-office functions to meet the needs of its growing banks while also preparing to meet its development objectives.

Near the close of 2005, a wealth management unit was formed, Capitol Wealth, Inc., which commenced operations in 2006 with an initiative to expand Capitol's banks' scope of services in meeting the needs of their clients beyond loans and deposits. Full time Capitol Wealth advisors will be located at Capitol's banks to work in tandem with their traditional banking colleagues. This new initiative is intended to expand the availability of financial services to the banks' clientele while increasing noninterest revenues. This activity commenced at selected banks beginning in early 2006 and will expand in coming years.

Capitol's Bank Development Strategy

Bank Development as a Defined Focus

Each new bank typically starts as a single-location office. Each is led by a bank president and a team of banking professionals with significant local experience, overseen by an independent board of directors composed of business leaders drawn from that local community. Each bank has complete *on-site authority* to make all decisions which directly affect the customer, such as credit approval and the pricing and structure of both loans and deposits. The notion of banking as a *profession* is key to Capitol's model where its banks' customers seek a relationship with *banking professionals* to meet their needs as opposed to transaction-oriented financial institutions pushing financial products at customers and emphasizing market share.

With Capitol's focused banking model, bank development on a national scale is a natural extension of this business philosophy. Capitol's bank development philosophy is based on just a few key ingredients necessary to start a new bank:

- A bank president candidate with a significant background in the future bank's business community, capable of attracting customer relationships and other banking professionals
- An office address from which to operate a bank, optimally located in that business community
- A strong group of potential board members, drawn from the local business community, to oversee the future bank's activities and assist in business development
- Availability of capital from community investors seeking to invest up to 49% in the required start-up equity of the future bank

Notably, 'market size' is not a big factor in Capitol's approach to bank-development. Rather, the key is people. Capitol's banks are small in market stature, emphasizing personalized banking relationships.

"Incubation" of Young Community Banks

New banks, just like most start-up businesses, are not profitable from the outset. Each new bank is started with sufficient capital to absorb early period losses and to support balance-sheet growth. During these early periods of operation, Capitol's management works closely with the *de novo* bank's president in providing guidance and assistance to help achieve the

bank's goals and objectives as it navigates toward future profitability. Near a *de novo* bank's 3rd anniversary of operation, Capitol typically offers the bank's community investors (up to 49% of the bank's start-up capital) an opportunity to exchange their bank investment for shares of Capitol's common stock, generally at 150% of the bank's shares' then current book value. The exchange offer (which is not a contractual obligation of Capitol) is generally subject to approval by the bank's shareholders. When the offer is made, the bank is often 'turning the corner' on cumulative profitability and the share-exchange enables the bank's shareholders to achieve both a return on their original investment in the bank and liquidity in the form of marketable shares of Capitol's common stock, if the shareholders elect to enter into the share-exchange transaction. In 2006, Capitol completed two share-exchange transactions; three share-exchange transactions were completed in 2005.

Monitoring and Managing Capitol's Investments in Community Banks

Capitol monitors and manages its investments in community banks through the bank performance group of its management team. Lead by regional presidents, Capitol's bank performance group assists the banks in the development of detailed budgets, monitors progress on the banks' business plans and reviews monthly operating results for each bank. Capitol's bank performance group executives also assist in the identification of bank development opportunities within their respective regions. In addition to the monitoring of operating results, Capitol assists the banks in managing capital, including funding supplemental capital when needed to support bank growth, and implementing asset/liability management strategies.

Capitol's unique relationship with its banks is multidimensional, as an investor, mentor and service provider. As investor, Capitol closely monitors the financial performance of its bank subsidiaries. Capitol's mentoring role of providing assistance and guidance when and where necessary to help enhance bank performance is most important for its youngest affiliates where guidance is needed during their early formative stages. Capitol provides efficient back-office support services which can be done centrally for all of its banks and which do not involve a direct interface with the bank customer, such as:

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

Total assets and revenues of each bank within Capitol's eastern regions are summarized below as of and for the years ended December 31, 2006 and 2005 (in \$1,000s):

	Total Assets		Total Revenues ⁽³⁾	
	2006	2005	2006	2005
<i>Eastern Regions:</i>				
Great Lakes Region:				
Ann Arbor Commerce Bank	\$ 310,407	\$ 320,075	\$ 23,598	\$ 24,035
Bank of Auburn Hills ⁽²⁾	31,559	10,848	1,849	348
Bank of Belleville ⁽²⁾	24,948	14,641	1,188	70
Bank of Maumee ⁽¹⁾	9,915		133	
Bank of Michigan ⁽²⁾	51,287	31,119	3,073	773
Brighton Commerce Bank	103,909	105,694	7,889	7,268
Capitol National Bank	256,741	246,132	17,531	16,118
Detroit Commerce Bank	106,233	84,979	8,634	6,466
Elkhart Community Bank	86,883	75,648	6,476	5,329
Evansville Commerce Bank ⁽¹⁾	20,772		591	
Goshen Community Bank	80,137	74,545	5,216	4,076
Grand Haven Bank	129,033	122,757	9,702	8,629
Kent Commerce Bank	86,916	78,939	6,800	6,304
Macomb Community Bank	101,353	93,497	7,713	6,498
Muskegon Commerce Bank	95,551	96,649	7,494	7,236
Oakland Commerce Bank	134,437	115,720	9,660	8,711
Ohio Commerce Bank ⁽¹⁾	14,466		199	
Paragon Bank & Trust	98,804	106,535	7,816	8,499
Portage Commerce Bank	179,413	183,018	14,813	14,122
Great Lakes Region Total	1,922,764	1,760,796	140,375	124,482
Southeast Region:				
Bank of Valdosta ⁽¹⁾	21,626		561	
Community Bank of Rowan ⁽¹⁾	45,503		1,870	
First Carolina State Bank	93,819	83,345	6,341	4,669
Peoples State Bank ⁽²⁾	32,714	31,620	2,629	1,415
Sunrise Bank of Atlanta ⁽¹⁾	16,990		912	
Southeast Region Total	210,652	114,965	12,313	6,084
Midwest Region—Summit Bank of Kansas City ⁽²⁾	19,529	9,152	841	40
Eastern Regions Total	\$ 2,152,945	\$ 1,884,913	\$ 153,529	\$ 130,606

Total assets and revenues for Capitol's western regions and footnotes relating to this table appear on the following page.

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Summary of total assets and revenues – continued (western regions' banks and consolidated totals):

	Total Assets		Total Revenues ⁽³⁾	
	2006	2005	2006	2005
Eastern Regions Total (from preceding page)	\$2,152,945	\$1,884,913	\$ 153,529	\$ 130,606
<i>Western Regions:</i>				
<i>Southwest Region:</i>				
1 st Commerce Bank ⁽¹⁾	14,829		202	
Arrowhead Community Bank	79,152	83,639	8,076	7,043
Asian Bank of Arizona ⁽¹⁾	20,248		781	
Bank of Las Vegas	67,478	58,315	5,331	4,130
Bank of Tucson	187,683	167,638	15,358	12,758
Black Mountain Community Bank	138,961	128,958	10,984	8,746
Camelback Community Bank	83,003	82,309	6,355	5,937
Desert Community Bank	93,914	78,907	7,464	5,749
East Valley Community Bank	35,954	43,352	3,202	3,606
Fort Collins Commerce Bank ⁽²⁾	54,410	27,427	3,641	943
Mesa Bank	165,822	132,775	15,798	10,890
Red Rock Community Bank	108,362	102,618	8,515	7,410
Southern Arizona Community Bank	85,912	98,849	6,629	6,032
Sunrise Bank of Albuquerque	59,798	61,812	4,796	5,169
Sunrise Bank of Arizona	119,785	111,204	10,347	10,630
Valley First Community Bank	72,333	72,759	5,629	4,694
Yuma Community Bank	74,477	61,523	6,049	4,629
Southwest Region Total	1,462,121	1,312,085	119,157	98,366
<i>California Region:</i>				
Bank of Escondido	82,412	70,807	5,115	3,790
Bank of San Francisco ⁽²⁾	28,122	13,685	1,649	286
Bank of Santa Barbara ⁽²⁾	42,559	14,386	2,138	16
Napa Community Bank	99,009	84,512	7,212	5,788
Point Loma Community Bank	43,715	34,213	3,185	2,061
Sunrise Bank of San Diego	71,170	66,809	5,800	5,616
California Region Total	366,987	284,412	25,099	17,557
<i>Northwest Region:</i>				
Bank of Bellevue ⁽²⁾	33,155	19,726	2,061	408
Bank of Everett ⁽¹⁾	20,061		489	
Northwest Region Total	53,216	19,726	2,550	408
Western Regions Total	1,882,324	1,616,223	146,806	116,331
Other, net	30,547	(25,415)	550	(1,450)
Consolidated totals	\$4,065,816	\$3,475,721	\$ 300,885	\$ 245,487

(1) Became a Capitol affiliate in 2006 and is included for periods after addition to the Capitol banking network.

(2) Became a Capitol affiliate in 2005 and is included for periods after addition to the Capitol banking network.

(3) Total revenues is the sum of interest income and noninterest income.

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Capitol's Results of Operations

Net income for 2006 approximated \$42 million, an 18% increase over the \$36 million earned in 2005. Net income for 2004 was \$26.7 million. Diluted earnings per share for 2006 amounted to \$2.57 compared to \$2.34 in 2005 and \$1.79 in 2004.

The table below summarizes for each of Capitol's eastern regions' banks, 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		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
<i>Eastern Regions:</i>									
Great Lakes Region:									
Ann Arbor Commerce Bank	\$ 3,739	\$ 4,007	\$ 4,234	14.19%	14.80%	16.24%	1.21%	1.22%	1.30%
Bank of Auburn Hills ⁽²⁾	(332)	(437)							
Bank of Belleville ⁽²⁾	(548)	(405)							
Bank of Maumee ⁽¹⁾	(619)								
Bank of Michigan ⁽²⁾	(343)	(1,017)							
Brighton Commerce Bank	845	1,097	1,091	8.93%	11.86%	13.09%	0.80%	1.02%	1.11%
Capitol National Bank	2,879	3,510	3,602	14.97%	18.62%	20.77%	1.20%	1.46%	1.59%
Detroit Commerce Bank	942	633	163	11.23%	9.15%	2.91%	0.99%	0.80%	0.27%
Elkhart Community Bank	948	726	703	11.18%	9.21%	9.76%	1.16%	0.97%	1.17%
Evansville Commerce Bank ⁽¹⁾	(851)								
Goshen Community Bank	383	47	405	5.58%	0.71%	6.34%	0.55%	0.08%	0.83%
Grand Haven Bank	1,284	999	(412)	11.75%	9.75%		1.01%	0.82%	
Kent Commerce Bank	365	678	578	4.72%	8.14%	7.01%	0.44%	0.79%	0.70%
Macomb Community Bank	58	442	867	0.66%	5.03%	9.83%	0.06%	0.47%	0.93%
Muskegon Commerce Bank	158	1,184	1,516	1.87%	12.52%	16.25%	0.16%	1.23%	1.70%
Oakland Commerce Bank	1,143	1,835	1,014	11.50%	17.75%	10.14%	0.94%	1.46%	0.77%
Ohio Commerce Bank ⁽¹⁾	(383)								
Paragon Bank & Trust	858	819	1,073	7.71%	7.18%	9.53%	0.85%	0.74%	1.00%
Portage Commerce Bank	2,706	2,940	2,862	16.72%	18.31%	20.54%	1.51%	1.56%	1.66%
Great Lakes Region Total	13,232	17,058	17,696						
Southeast Region:									
Bank of Valdosta ⁽¹⁾	(822)								
Community Bank of Rowan ⁽¹⁾	(1,095)								
First Carolina State Bank ⁽³⁾	637	478	445	5.59%	4.42%	4.31%	0.75%	0.64%	0.66%
Peoples State Bank ⁽²⁾	282	77		6.57%	2.90%		0.55%	0.36%	
Sunrise Bank of Atlanta ⁽¹⁾	(820)								
Southeast Region Total	(1,818)	555	445						
Midwest Region—Summit Bank of Kansas City ⁽²⁾	(593)	(319)							
Eastern Regions Total	\$ 10,821	\$ 17,294	\$ 18,141						

Net income and the related rates of return on average equity and assets for Capitol's western regions and footnotes relating to this table appear on the following page.

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Net income and the related rates of return on average equity and assets – continued (western regions' banks and consolidated totals):

	Net Income			Return on Average Equity			Return on Average Assets		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Eastern Regions Total (from preceding page)	\$ 10,821	\$ 17,294	\$ 18,141						
<i>Western Regions:</i>									
<i>Southwest Region:</i>									
1 st Commerce Bank ⁽¹⁾	(432)								
Arrowhead Community Bank	1,293	1,255	758	15.68%	17.47%	12.53%	1.49%	1.56%	1.14%
Asian Bank of Arizona ⁽¹⁾	(567)								
Bank of Las Vegas	707	670	224	7.24%	9.70%	3.65%	1.09%	1.16%	0.41%
Bank of Tucson	4,656	3,732	2,962	29.93%	27.61%	24.69%	2.62%	2.12%	1.86%
Black Mountain Community Bank	2,556	2,204	1,428	20.40%	20.95%	16.20%	1.96%	1.84%	1.50%
Camelback Community Bank	1,119	1,167	554	13.64%	13.90%	6.24%	1.36%	1.42%	0.68%
Desert Community Bank	1,302	1,061	634	15.29%	13.65%	8.18%	1.51%	1.42%	1.05%
East Valley Community Bank	514	313	219	9.51%	6.38%	5.12%	1.27%	0.67%	0.49%
Fort Collins Commerce Bank ⁽²⁾	170	(396)		2.10%			0.42%		
Mesa Bank	3,995	2,808	1,659	32.56%	31.37%	22.83%	2.59%	2.45%	1.91%
Red Rock Community Bank	2,162	1,856	806	17.38%	15.32%	6.47%	2.09%	1.73%	0.75%
Southern Arizona Community Bank	1,189	1,290	1,291	13.51%	14.74%	15.47%	1.39%	1.46%	1.54%
Sunrise Bank of Albuquerque	494	929	770	7.50%	13.58%	12.53%	0.86%	1.36%	1.09%
Sunrise Bank of Arizona	1,372	2,215	2,674	10.82%	18.12%	23.27%	1.17%	1.82%	2.03%
Valley First Community Bank	716	604	310	9.67%	9.06%	5.11%	0.97%	0.86%	0.60%
Yuma Community Bank	1,199	992	915	16.95%	14.88%	15.59%	1.70%	1.66%	1.74%
Southwest Region Total	22,445	20,700	15,204						
<i>California Region:</i>									
Bank of Escondido	787	452	(186)	7.70%	4.78%		1.04%	0.72%	
Bank of San Francisco ⁽²⁾	(484)	(726)							
Bank of Santa Barbara ⁽²⁾	(630)	(514)							
Napa Community Bank	1,572	965	579	13.65%	9.47%	6.80%	1.86%	1.27%	0.87%
Point Loma Community Bank ⁽³⁾	196	(467)	(703)	2.84%			0.48%		
Sunrise Bank of San Diego	885	1,095	1,104	8.18%	10.18%	11.26%	1.27%	1.69%	1.58%
California Region Total	2,326	805	794						
<i>Northwest Region:</i>									
Bank of Bellevue ⁽²⁾	(384)	(551)							
Bank of Everett ⁽¹⁾	(733)								
Northwest Region Total	(1,117)	(551)							
Western Regions Total	23,654	20,954	15,998						
Other, net	7,916	(2,323)	(7,423)						
Consolidated totals	\$ 42,391	\$35,925	\$26,716	12.94%	13.34%	11.25%	1.12%	1.08%	0.91%

- (1) Became a Capitol affiliate in 2006 and is included for periods after addition to the Capitol banking network.
(2) Became a Capitol affiliate in 2005 and is included for periods after addition to the Capitol banking network.
(3) Became a Capitol affiliate in 2004 and is included for periods after addition to the Capitol banking network.

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The principal revenue source for Capitol's banks is interest income from loans. 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 \$173.8 million in 2006, an 11% increase over the \$156.9 million reported in 2005. This increase is due to a combination of several factors. In total, net interest income increased \$16.9 million which was comprised of an increase in interest income of about \$55 million, partially offset by an increase in interest expense of about \$38 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 increase in interest income includes approximately \$33 million resulting from higher levels of loans outstanding in 2006 (i.e., volume), plus an increase of \$22 million due to higher rates as loans repriced or were refinanced at rising rates in 2006. Similarly, the \$38 million increase in interest expense is comprised of two components: \$10 million from larger balances and \$28 million from higher interest rates.

Net interest income increased about \$25.3 million in 2005. Most of that net increase resulted from an increase in interest income of \$45 million (of which about half resulted from loan growth in 2005) and from an increase in interest expense of \$20 million primarily associated with larger liability balances and higher interest rates.

Combined with noninterest income, total consolidated net operating revenue approximated \$195.3 million in 2006, \$177.9 million in 2005 and \$150.8 million in 2004. Noninterest income for these periods was \$21.5 million, \$21 million and \$19.3 million, respectively.

Noninterest income, in total, has been relatively consistent, but with several important changes in its components. In 2006, 2005 and 2004, revenue from mortgage loans originated for sale amounted to \$5.4 million, \$6.1 million and \$5.6 million, respectively. Loan origination volume decreased in 2006 and 2005, compared to 2004 levels, due to higher interest rates. Increased rates have substantially reduced origination volume from refinancings. Further, reduction in home sales volume in some communities (particularly within the state of Michigan) has also negatively impacted origination volume. Other noninterest income remained relatively steady in 2006, but increased significantly in 2005, primarily from fees from origination of non-portfolio commercial loans. Due to the nature of these revenues, as well as gains on the sale of government-guaranteed loans, the amount of the revenue can vary significantly from year to year depending on interest rates and business opportunities. Revenue from trust and wealth management activities increased more than 50% in 2006, rebounding from a large decrease in 2005.

The provision for loan losses approximated \$12.2 million, \$11 million and \$12.7 million in 2006, 2005 and 2004, 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 \$137.8 million, \$117.3 million and \$97.8 million in 2006, 2005 and 2004, respectively. In total, these expenses increased 17.5% in 2006, 19.9% in 2005 and 12.5% in 2004. Increases in the components of noninterest expense in 2006 were primarily associated with added staffing and other costs associated with growing young banks and adding new banks (nine in each of 2006 and 2005). The lower rate of increase in 2004 was the result of a slower pace of adding new banks (two added in 2004). The more significant elements of other noninterest expense consisted of the following (in \$1,000s):

	2006	2005	2004
Preopening and start-up costs of <i>de novo</i> banks and bank- development subsidiaries	\$ 4,462	\$ 2,971	448
Advertising	2,921	2,266	1,981
Professional fees	2,547	2,124	2,046
Paper, printing and supplies	2,409	2,135	1,697
Directors' fees	2,196	1,577	914
Taxes other than income taxes	1,372	1,401	1,010
Bank services (ATMs, telephone banking and Internet banking)	1,564	1,229	1,123
Communications	1,380	1,229	996
Other	13,252	13,866	10,006
Total	<u>\$ 32,103</u>	<u>\$ 28,798</u>	<u>\$ 20,221</u>

Capitol's effective tax rate was 34.1% in 2006, 38.7% in 2005 and 36.4% in 2004. 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 (which are shown in the table above). The lower effective tax rate in 2006 resulted primarily from state income tax benefits.

Capitol's Financial Position

Capitol completed 2006 with a milestone in consolidated total assets. Total assets grew to \$4.1 billion from \$3.5 billion at the end of 2005 and \$3.1 billion at the beginning of 2005.

Key to the balance-sheet strength of Capitol is its total capital position (subordinated debentures, minority interests in consolidated subsidiaries and stockholders' equity totaling approximately \$589.4 million or 14.5% of total assets) and liquidity (cash and cash equivalents of \$348.9 million or 8.6% of total assets) at December 31, 2006. 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 after subtracting the allowance for loan losses) approximated \$3.4 billion at December 31, 2006 and \$3 billion at December 31, 2005. These amounts approximated 85% of total consolidated assets at December 31, 2006 and 2005. 2006 loan growth approximated \$497.5 million. On a consolidated basis, portfolio loan growth at banks less than three years of age as of year-end 2006 approximated 61% of all banks' portfolio loan growth, which is the expected result of Capitol's growing number of banks.

Capitol's banks emphasize commercial loans, consistent with their focus on lending to local entrepreneurs, professional service firms and other businesses. All of Capitol's banks use a common credit policy; however, as emphasized earlier, all credit decisions are made at the local level at each community bank. The utilization of an 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 amongst other affiliates or other funding sources, when proposals exceed an individual bank's limitations
- Collections and workouts
- Documenting and evaluating 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 sought as the primary source of collateral for commercial loans when possible. 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 appropriate loan-to-value ratios, avoidance of large real estate development projects and the belief that, even in soft economies, commercial real estate tends to have substantially less loss potential than other types of business-asset collateral, such as receivables, inventory and equipment.

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 can be long due to the foreclosure process and further extended if the real estate sales environment is weak in particular markets. In contrast, a commercial loan secured by receivables, inventory or equipment which becomes nonperforming tends to have a higher loss potential due to the probable dissipation of collateral value.

At December 31, 2006, the consolidated allowance for loan losses approximated \$45.4 million or 1.30% of total portfolio loans outstanding, compared with \$40.6 million or 1.36% at December 31, 2005 and \$37.6 million or 1.40% at the beginning of 2005. As stated earlier, the allowance is based on management's analysis of inherent losses in the portfolio at the balance sheet date.

Nonperforming loans approximated \$34.3 million and \$26.7 million at December 31, 2006 and 2005, and approximated 0.98% and 0.89% of portfolio loans and 0.84% and 0.77% of total assets, respectively. Of the nonperforming loans at December 31, 2006, about 79% were real-estate secured. At December 31, 2006, the coverage ratio of the allowance for loan losses to nonperforming loans (i.e., the allowance as a percentage of nonperforming loans) was 132.5%, compared to 151.7% at the beginning of the year.

At December 31, 2006, about 85% of Capitol's total nonperforming loans were carried at Michigan-based banks where nonperforming loans increased \$5.7 million or 24% in 2006. In concert with elevated levels of nonperforming loans at Michigan banks, their combined allowance ratio of about 1.50% of portfolio loans at year-end 2006 and 2005 has been maintained at a higher level than the consolidated ratio. Due to a combination of commercial real estate collateral and a weak economic climate (which has Michigan largely viewed as a one-state recession), resolution of nonperforming loans and other nonperforming assets may take extended periods, levels of nonperforming loans could increase further and general economic conditions may not improve in the near term. Management believes that nonperforming loans have been properly considered in its evaluation of the adequacy of the allowance for loan losses as of December 31, 2006.

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, assessing the financial strength of the borrower and guarantors and other factors such as the borrowers' historical and projected financial performance, 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 attention and the development of specific remedial action plans.

At December 31, 2006, potential problem loans (which includes nonperforming loans) approximated \$146 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 proactive 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. These loans are considered in management's evaluation of the adequacy of the allowance for loan losses.

As noted in the *Critical Accounting Policies* section which appears later in this narrative, the use of estimates in determining the allowance for loan losses is very important for 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 net 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. Management's experience is that its estimation techniques have accurately determined historical losses.

Capitol had 50 separately chartered banks at year-end 2006. 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 includes elements for all portfolio loan categories for performing loans, nonperforming loans, watch credits and environmental factors. While a standardized template is utilized, management is required to apply subjective judgment in determining risk factors specific to their banks and other matters in determining 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 to evaluate and determine the adequacy of the allowance for loan losses at each individual bank and on a consolidated basis is labor intensive and requires a high degree of judgment. It is possible that others, given the same information, may at any point in time reach different reasonable conclusions.

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The following table summarizes portfolio loans, the allowance for loan losses and nonperforming loans for each of the banks, regionally, and on a consolidated basis (in \$1,000s):

	Total Portfolio Loans		Allowance for Loan Losses		Nonperforming Loans		Allowance as a % of Total Portfolio Loans	
	2006	2005	2006	2005	2006	2005	2006	2005
<i>Eastern Regions:</i>								
Great Lakes Region:								
Ann Arbor Commerce Bank	\$ 288,408	\$ 286,146	\$ 4,393	\$ 4,712	\$ 4,441	\$ 3,103	1.52%	1.65%
Bank of Auburn Hills ⁽²⁾	26,432	6,058	410	90	629		1.55%	1.49%
Bank of Belleville ⁽²⁾	17,410	1,534	260	23			1.49%	1.50%
Bank of Maumee ⁽¹⁾	3,327		50				1.50%	
Bank of Michigan ⁽²⁾	44,630	28,062	669	421			1.50%	1.50%
Brighton Commerce Bank	94,987	93,553	995	978	522	1,412	1.05%	1.05%
Capitol National Bank	196,074	197,062	2,833	3,233	3,365	4,938	1.44%	1.64%
Detroit Commerce Bank	103,153	81,533	1,335	1,104	1,328	110	1.29%	1.35%
Elkhart Community Bank	77,515	70,671	1,010	919	676	908	1.30%	1.30%
Evansville Commerce Bank ⁽¹⁾	14,711		232				1.58%	
Goshen Community Bank	63,653	53,497	862	648	233	443	1.35%	1.21%
Grand Haven Bank	120,025	117,241	2,643	2,575	2,682	3,342	2.20%	2.20%
Kent Commerce Bank	83,065	74,385	1,237	1,277	2,256	1,751	1.49%	1.72%
Macomb Community Bank	87,737	90,448	1,670	1,422	3,738	2,142	1.90%	1.57%
Muskegon Commerce Bank	81,799	88,007	1,231	1,021	3,906	1,430	1.50%	1.16%
Oakland Commerce Bank	114,876	101,859	1,636	1,424	2,862	948	1.42%	1.40%
Ohio Commerce Bank ⁽¹⁾	739		11				1.49%	
Paragon Bank & Trust	82,259	92,427	1,298	1,375	2,132	2,216	1.58%	1.49%
Portage Commerce Bank	167,005	171,679	1,729	2,057	1,380	2,119	1.04%	1.20%
Great Lakes Region Total	1,667,805	1,554,162	24,504	23,279	30,150	24,862	1.47%	1.50%
Southeast Region:								
Bank of Valdosta ⁽¹⁾	18,870		283				1.50%	
Community Bank of Rowan ⁽¹⁾	36,534		534				1.46%	
First Carolina State Bank	73,884	68,235	800	690	150	173	1.08%	1.01%
Peoples State Bank ⁽²⁾	15,154	19,909	263	140		16	1.74%	0.70%
Sunrise Bank of Atlanta ⁽¹⁾	14,553		215				1.48%	
Southeast Region Total	158,995	88,144	2,095	830	150	189	1.32%	0.94%
Midwest Region—Summit Bank of Kansas City ⁽²⁾								
	15,645	644	235	10			1.50%	1.55%
Eastern Regions Total	\$ 1,842,445	\$ 1,642,950	\$ 26,834	\$ 24,119	\$ 30,300	\$ 25,051	1.46%	1.47%

Loan information for Capitol's western regions, consolidated totals and footnotes relating to this table appear on the following page.

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Summary of loan information – continued:

	Total Portfolio Loans		Allowance for Loan Losses		Nonperforming Loans		Allowance as a % of Total Portfolio Loans	
	2006	2005	2006	2005	2006	2005	2006	2005
Eastern Regions Total (from preceding page)	\$ 1,842,445	\$ 1,642,950	\$ 26,834	\$ 24,119	\$ 30,300	\$ 25,051	1.46%	1.47%
<i>Western Regions:</i>								
Southwest Region:								
1 st Commerce Bank ⁽¹⁾	9,588		125				1.30%	
Arrowhead Community Bank	71,252	73,800	720	654	855	140	1.01%	0.89%
Asian Bank of Arizona ⁽¹⁾	14,499		200				1.38%	
Bank of Las Vegas	62,818	50,899	705	495			1.12%	0.97%
Bank of Tucson	160,009	143,900	1,472	1,405	199	200	0.92%	0.98%
Black Mountain Community Bank	127,844	103,627	1,529	1,277		131	1.20%	1.23%
Camelback Community Bank	78,922	73,813	733	852	46	41	0.93%	1.15%
Desert Community Bank	83,284	71,050	830	830	137	273	1.00%	1.17%
East Valley Community Bank	31,884	38,716	321	497			1.01%	1.28%
Fort Collins Commerce Bank ⁽²⁾	52,147	22,619	695	306			1.33%	1.35%
Mesa Bank	157,979	125,513	1,473	1,215			0.93%	0.97%
Red Rock Community Bank	100,010	83,259	1,084	1,300	151	198	1.08%	1.56%
Southern Arizona Community Bank	77,845	76,953	775	720	16	59	1.00%	0.94%
Sunrise Bank of Albuquerque	53,027	53,669	778	693		300	1.47%	1.29%
Sunrise Bank of Arizona	112,720	101,846	1,126	1,253	246	70	1.00%	1.23%
Valley First Community Bank	66,256	57,794	611	526			0.92%	0.91%
Yuma Community Bank	58,577	50,474	500	485		27	0.85%	0.96%
Southwest Region Total	1,318,661	1,127,932	13,677	12,508	1,650	1,439	1.04%	1.11%
California Region:								
Bank of Escondido	37,398	38,228	370	460	19	23	0.99%	1.20%
Bank of San Francisco ⁽²⁾	26,415	7,291	375	102			1.42%	1.40%
Bank of Santa Barbara ⁽²⁾	40,198	3,546	533	54			1.33%	1.52%
Napa Community Bank	78,467	70,359	1,020	1,237		19	1.30%	1.76%
Point Loma Community Bank	38,018	29,759	510	423			1.34%	1.42%
Sunrise Bank of San Diego	65,250	58,983	540	588		200	0.83%	1.00%
California Region Total	285,746	208,166	3,348	2,864	19	242	1.17%	1.38%
Northwest Region:								
Bank of Bellevue ⁽²⁾	28,037	8,327	370	120			1.32%	1.44%
Bank of Everett ⁽¹⁾	8,269		122				1.48%	
Northwest Region Total	36,306	8,327	492	120			1.36%	1.15%
Western Regions Total	1,640,713	1,344,425	17,517	15,492	1,669	1,681	1.07%	1.15%
Other, net	5,520	3,814	1,063	948	2,305			
Consolidated totals	<u>\$ 3,488,678</u>	<u>\$ 2,991,189</u>	<u>\$ 45,414</u>	<u>\$ 40,559</u>	<u>\$ 34,274</u>	<u>\$ 26,732</u>	<u>1.30%</u>	<u>1.36%</u>

- (1) Became a Capitol affiliate in 2006 and is included for periods after addition to the Capitol banking network.
(2) Became a Capitol affiliate in 2005 and is included for periods after addition to the Capitol banking network.

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There are several other asset categories. Loans held for sale (\$34.6 million and \$21.6 million at December 31, 2006 and 2005, respectively) are home mortgages which are presold to the secondary market that generally are collected in 30-60 days (discussed in more detail in the following section of this narrative). There is also a modest amount of investment securities on the balance sheet (\$40.7 million and \$43.7 million at December 31, 2006 and 2005, respectively). Goodwill and other intangibles increased to \$62.2 million at year-end 2006, an increase of \$11.8 million primarily resulting from share-exchange transactions; accounting for goodwill is described in the *Critical Accounting Policies* section of this narrative. All other asset categories are individually less than \$65 million at December 31, 2006 and 2005.

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 sale and investment securities available for sale. These categories totaled \$402.4 million at year-end 2006, or about 9.9% of total assets. This compares to \$353.7 million or about 10.2% of total assets at year-end 2005. 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 can vary significantly on a daily basis, based on customer activity.

About half of the investment securities portfolio is classified as available for sale, although the banks generally have not sold investments to meet liquidity needs. During 2006, there were no sales of investment securities available for sale, compared with \$1.8 million in 2005 and \$59.6 million in 2004. Sales of investment securities available for sale in 2005 and 2004 were primarily related to changes in risk-management strategies.

Loans held for sale, as previously mentioned, approximated \$34.6 million at December 31, 2006, compared to \$21.6 million at year-end 2005. 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 2006 decreased 24%, to approximately \$483.9 million compared to \$634.4 million in 2005 and \$715.2 million in 2004. The decrease in volume was primarily due to higher interest rates in 2005 and 2006 after record low interest rates, refinancing volume and home sale activity as discussed previously. Future volume will depend in large part on interest rates and the relative strength of residential real estate market conditions. Also, to the extent warranted, the banks may sell other loans from time to time.

The primary source of funds for the banks is deposits. The banks rely upon interest-bearing time deposits as part of their funding strategy. The banks also emphasize 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 2006 (about 21% at year-end 2005) and increased \$60 million, or 10%, 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 sourcing and pricing has become more competitive. Deposit growth is achievable, but at a competitive price, with tight net interest margins, especially during periods of relatively low interest rates. As interest rates increase, customers are more attracted to competitively-priced time deposits, and growth in non-interest bearing balances is more difficult to achieve. The banks do not generally rely on brokered deposits as a key funding source (approximately \$354 million at year-end 2006 or 13.6% of interest-bearing deposits compared to 10.8% in 2005); however, brokered deposits are a ready resource to help meet funding needs, such as loan commitments (which are discussed in greater detail in Note O of the consolidated financial statements), and manage interest rate risk.

To supplement their funding sources, some of the banks have lines of credit from the Federal Home Loan Bank system. At year-end 2006, a total of approximately \$184 million (\$173 million at year-end 2005) was borrowed under those facilities and additional borrowing availability approximated \$379 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 2006 and 2005, 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, the principal amounts of which are summarized as follows (in \$1,000s):

	Total ⁽¹⁾	Payments Due by Period			
		Within 1 Year	Within 1-3 Years	Within 3-5 Years	After 5 Years
Deposits without a stated maturity	\$1,838,252	\$1,838,252			
Time deposits	1,420,233	1,153,331	\$ 204,984	\$ 59,282	\$ 2,636
Debt obligations	191,154	125,314	33,128	32,594	118
Rent commitments under noncancelable leases	41,898	7,167	11,973	9,478	13,280
Trust-preferred securities	<u>103,300</u>				<u>103,300</u>
Total	<u>\$3,594,837</u>	<u>\$3,124,064</u>	<u>\$ 250,085</u>	<u>\$ 101,354</u>	<u>\$ 119,334</u>

(1) Excludes interest.

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 on the preceding page; please refer to the later interest-rate sensitivity table regarding all deposit maturities. Other than the items set forth on the preceding page, there are no individually material contractual obligations, such as purchase obligations.

A significant source of capital has been investments made by community investors, or minority shareholders, in the subsidiaries which are consolidated for financial reporting purposes. Total minority interests in consolidated subsidiaries amounted to \$126.5 million at year-end 2006, a net increase of \$42.7 million from the \$83.8 million level at year-end 2005. The net increase in minority interests in 2006 resulted mainly from Capitol's formation of new banks and bank-development subsidiaries.

Capitol has formed several bank-development subsidiaries, each capitalized with two classes of common stock, voting and nonvoting. All of the voting common stock (an investment of \$1 million for each entity) is owned by Capitol. All of the nonvoting common stock, ranging from \$9.9 million to \$15.8 million for each of the bank-development companies, was sold in private offerings to accredited investors, some of whom are related parties of Capitol. These entities are engaged in bank development activities, through Capitol, either on a *de novo* basis or through acquisition opportunities. Each of these entities bear a similar name, Capitol Development Bancorp Limited ("CDBL"), numbered in their sequential formation, CDBL-I through CDBL-VI. CDBL-I became wholly-owned via a share-exchange with Capitol effective November 30, 2006. At December 31, 2006, Capitol had presented an exchange offer to the holders of CDBL-II's nonvoting common stock, which was approved by those shareholders and became effective February 2007; Capitol completed that share-exchange through the issuance of approximately 371,000 shares of previously unissued common stock.

Two subsidiaries became wholly-owned from share-exchange transactions completed in 2006 which resulted in the issuance of about 555,000 shares of Capitol's common stock. In these transactions, the shares acquired from the minority shareholders were exchanged for Capitol's common stock according to fixed, but differing, exchange ratios. In 2005, Capitol similarly completed three separate share-exchange transactions which resulted in the issuance of approximately 610,000 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 offers such an exchange and whether minority shareholders vote in favor of it on a transaction-by-transaction basis.

Capitol generally adds banks on a *de novo* or start-up basis. Capitol does, however, consider bank acquisition opportunities, particularly when such opportunities facilitate entry into a state where Capitol did not previously have a presence. In April 2005, Capitol acquired a majority interest in Peoples State Bank located in Jeffersonville, Georgia. In April 2004, Capitol acquired First Carolina State Bank, which is located in Rocky Mount, North Carolina. The pro forma effects of these acquisitions were not significant.

Capitol's capital structure consists of these primary elements:

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

Total stockholders' equity approximated \$361.9 million at year-end 2006, an increase of \$60 million for the year. The 2006 increase in stockholders' equity includes earnings (less dividends paid), the previously-mentioned share-exchange transactions and proceeds from the issuance of common stock from the exercise of stock options. The book value per share of common stock (i.e., stockholders' equity divided by the number of common shares outstanding) was \$21.73 at year-end 2006, compared with \$19.13 at year-end 2005. Cash dividends per share of \$0.95 were paid in 2006, compared to \$0.72 in 2005 and \$0.65 in 2004. In early 2007, Capitol's board of directors approved a first-quarter cash dividend of \$0.25 per share. 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.

Minority interests in consolidated subsidiaries represent the underlying noncontrolling interests in the equity of banks and bank-development subsidiaries owned by others. Those shareholders include some shareholders of Capitol; however, these equity interests are separate from their ownership of Capitol's common stock. These minority interests increase as new banks are added with investors other than Capitol, decrease when minority interests are exchanged for Capitol's common stock (and those interests then "migrate" to Capitol's stockholders' equity) and increase or decrease for the minority interests' share of their entity's income or losses.

Capitol has previously raised a total of \$103.3 million of capital through issuance of trust-preferred securities. Most of these funds have been obtained through private placements of pooled trust-preferred securities. Trust-preferred securities are long-term debt obligations which 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 on the consolidated balance sheet.

Total capitalization at year-end 2006 amounted to \$589.4 million, or 14.5% of total assets. This compares to \$486.6 million, or 14% at year-end 2005.

At December 31, 2006, Capitol and its bank-development subsidiaries had \$34.9 million of funds available for deployment into formation of new banks and/or other corporate purposes.

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, Capitol and its banks met the criteria to be classified as *well capitalized* at year-end 2006.

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.

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Changes in interest rates, either up or down, have an impact on net interest income (plus or minus), depending upon 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, 2006 (in \$1,000s):

	Interest Rate Sensitivity				Total
	0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years	
ASSETS					
Money market and interest-bearing deposits	\$ 17,707	\$ 19,101	\$ 396		\$ 37,204
Federal funds sold	141,913				141,913
Loans held for sale	34,593				34,593
Investment securities	17,937	2,068	6,926	\$ 13,722	40,653
Portfolio loans:					
Commercial	1,280,104	251,326	1,449,943	121,752	3,103,125
Real estate mortgage	201,354	20,851	30,654	6,745	259,604
Installment	32,161	24,506	60,415	8,867	125,949
Nonearning assets					322,775
Total assets	\$ 1,725,769	\$ 317,852	\$ 1,548,334	\$ 151,086	\$ 4,065,816
LIABILITIES AND STOCKHOLDERS' EQUITY					
Interest-bearing deposits:					
Time deposits under \$100,000	\$ 123,976	\$ 230,873	\$ 103,750	\$ 1,605	\$ 460,204
Time deposits \$100,000 and over	363,192	435,290	160,516	1,031	960,029
All other interest-bearing deposits	813,859	204,211	82,601	86,327	1,186,998
Total interest-bearing deposits	1,301,027	870,374	346,867	88,963	2,607,231
Notes payable and short-term borrowings	57,380	67,934	65,722	118	191,154
Trust preferred securities	48,000			55,300	103,300
Noninterest-bearing liabilities					675,740
Minority interests in consolidated subsidiaries					126,512
Stockholders' equity					361,879
Total liabilities and stockholders' equity	\$ 1,406,407	\$ 938,308	\$ 412,589	\$ 144,381	\$ 4,065,816
Interest rate sensitive period gap	\$ 319,362	\$ (620,456)	\$ 1,135,745	\$ 6,705	
Interest rate sensitive cumulative gap	\$ 319,362	\$ (301,094)	\$ 834,651	\$ 841,356	
Period rate sensitive assets/period rate sensitive liabilities	1.23	0.34	3.75	1.05	
Cumulative rate sensitive assets/cumulative rate sensitive liabilities	1.23	0.87	1.30	1.29	
Cumulative gap to total assets	7.85%	(7.41)%	20.53%	20.69%	

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 customers' balances and transactions.

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. 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	\$ 308,683	\$ 328,927	\$ 349,237	\$ 288,704	\$ 268,648
Interest expense	<u>142,855</u>	<u>162,108</u>	<u>181,260</u>	<u>122,872</u>	<u>102,888</u>
Net interest income	<u>\$ 165,828</u>	<u>\$ 166,819</u>	<u>\$ 167,977</u>	<u>\$ 165,832</u>	<u>\$ 165,760</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 timely and the availability of funds for customers to make deposits. As discussed earlier, Michigan's economic climate has been weak and is somewhat uncertain. Capitol's Michigan-based banks have minimal amounts of loans made directly to auto industry-related businesses; however, the stress of the U.S. auto industry and weaknesses in other commerce in Michigan is likely to have some adverse impact on the communities in which the banks are located. 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.

Bank regulatory agencies have recently issued commentary regarding asset concentrations, with particular emphasis on commercial real estate when used as collateral for loans. As discussed elsewhere, Capitol's banks intentionally seek commercial real estate as collateral when making loans because its experience suggests lower loss potential on those loans than ones merely secured by accounts receivable, inventory or equipment. Further, many of these loans at Capitol's banks are made to borrowers with owner-occupied businesses, where the real estate collateral is obtained as part of a broader collateral package for business loans, with less emphasis on loans solely dependent on speculative real estate development projects.

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 handling of customer relationships as perceived 'commodities' by the larger banks, many customer relationships have been displaced, generating opportunities for cultivation by Capitol's banks, as well as opportunities for development of new banks where Capitol has not previously had banks. For many 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 and professional 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 relative operational 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 operation. Recently-formed start-up banks will detract from consolidated earnings performance and additional start-up banks formed in 2007 and beyond will similarly negatively impact short-term consolidated 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. FDIC deposit insurance premium levels will become a more significant expense in 2007 and beyond as the FDIC imposes a risk-based matrix approach for assessment of premiums for deposit insurance.

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

Critical Accounting Policies Affecting Capitol's Financial Statements

Note B of the notes to the consolidated financial statements is captioned *Significant Accounting Policies*. That disclosure spans numerous pages, all of which are deemed "significant" and are required disclosures under generally accepted accounting principles (GAAP). For purposes of this narrative, current SEC guidance requires 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 within the business of 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 releases on how financial institutions are to determine the amount of their allowance for loan losses. Some of this guidance is very recent. Determining the allowance is really a process and methodology which is inherently subjective 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, combined with judgmental factors unique to the loan portfolio at each bank, 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. The process of determining the level of the allowance for loan losses at each individual bank and on a consolidated basis requires a high degree of subjective judgment. It is possible that others, given the same information, may at any point in time reach different reasonable conclusions. At December 31, 2006, Capitol's allowance for loan losses approximated 1.30% 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 \$350,000 impact on both the allowance for loan losses and income before income taxes.

Accounting for Goodwill and Other Intangibles. At December 31, 2006, Capitol had \$62.2 million of 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. Current accounting rules require an annual review of goodwill for potential impairment. Goodwill is reviewed for impairment by management by comparing estimated entity fair value (using bank sale transaction multiples) to net assets of the entity. 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, 2006.

Accounting for Stock Options. A new accounting standard became effective for Capitol January 1, 2006, which changed its method of accounting for stock options, requiring expense recognition for share-based payments.

Like many companies, Capitol has granted stock options to its officers and directors and, as permitted under accounting rules in effect through December 31, 2005, did not require treating stock options as an element of compensation expense. This is because Capitol used the so-called intrinsic-value method for accounting for stock options, which ascribed 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 Capitol's common stock at the grant date. When using that method, Capitol had 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.

It is difficult to estimate what future impact the accounting rule change may have on future incentive awards, but it may result in extended vesting periods for future stock option grants, use of restricted stock awards or stock appreciation rights as a replacement of stock options in future periods or a combination of these or other long-term incentives.

While the new rules apply prospectively to stock options granted after the 2006 effective date mentioned previously, it also applies to any previously granted but unvested stock options at that effective date. No stock options were granted in 2006. Capitol accelerated the vesting of any previously unvested stock options prior to January 1, 2006, for the purpose of avoiding expense recognition, as permitted with the rule changes, relating to those stock options.

Consolidation Policy. Current accounting rules require consolidation of entities which are majority-owned or controlled by Capitol. This means that partially-owned banks and bank-development subsidiaries are combined with Capitol for financial reporting purposes along with banks and other subsidiaries which are wholly-owned. The consolidated balance sheet includes all assets and liabilities of those entities. Capitol's net income, however, only includes the entities' net income or loss to the extent of Capitol's ownership. Reported results would be materially different if Capitol had 100% ownership of those entities. Capitol has typically gained full ownership at a later date through share-exchange transactions.

New Accounting Standards

There were several new accounting standards which were issued or became effective in 2006, 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-48.

Risk Factors Affecting Capitol and its Banks

Current SEC reporting guidance suggests this narrative identify risk factors of the reporting entity in summary form. The summary below is not a complete list of all risk factors identified by management and readers are encouraged to review Capitol's other SEC filings, particularly registration statements, for a more comprehensive review of risk factors, which include the following:

- The favorable environment for formation of new banks could change adversely
- New banks, which include Capitol's younger affiliates, incur operating losses and may not contribute to consolidated earnings for a period of time

- The favorable environment which has made both capital and management talent readily available for formation of new banks could change adversely
- Changes in regulations, or regulatory action regarding Capitol or its banks could limit future expansion plans
- The consolidated allowance for loan losses is based on estimates
- Concentrations in loans secured by commercial real estate could limit or delay future expansion plans and loss estimates could change significantly if real estate market conditions deteriorate
- The complexity of Capitol's structure (a mixture of partially-owned and wholly-owned banks and related entities) complicates financial analysis

In addition to the items listed above, of course, changes in interest rates can have a pervasive impact on Capitol and its banks.

Capitol has a risk management program in place which endeavors to manage these and other risks.

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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, 2006, 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, 2006, 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 14, 2007



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. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway 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 Corporation'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. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, Capitol Bancorp Ltd. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the accompanying consolidated balance sheets as of December 31, 2006 and 2005, 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, 2006, of Capitol Bancorp Ltd. and subsidiaries and our report dated March 14, 2007 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Grand Rapids, Michigan
March 14, 2007



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, 2006 and 2005, 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, 2006. 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, 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, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, 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. and subsidiaries' internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 14, 2007 expressed an unqualified opinion thereon.

Grand Rapids, Michigan
March 14, 2007

Consolidated Balance Sheets

	-December 31-	
	2006	2005
	(in \$1,000s)	
ASSETS		
Cash and due from banks	\$ 169,753	\$ 157,963
Money market and interest-bearing deposits	37,204	19,846
Federal funds sold	<u>141,913</u>	<u>128,299</u>
Cash and cash equivalents	348,870	306,108
Loans held for sale	34,593	21,638
Investment securities—Note C:		
Available for sale, carried at market value	18,904	25,929
Held for long-term investment, carried at amortized cost which approximates market value	<u>21,749</u>	<u>17,745</u>
Total investment securities	40,653	43,674
Portfolio loans, less allowance for loan losses of \$45,414 in 2006 and \$40,559 in 2005—Note D	3,443,264	2,950,630
Premises and equipment—Note F	54,295	41,629
Accrued interest income	17,524	13,719
Goodwill and other intangibles—Notes B and R	62,215	50,378
Other assets	<u>64,402</u>	<u>47,945</u>
TOTAL ASSETS	<u>\$ 4,065,816</u>	<u>\$ 3,475,721</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest bearing	\$ 651,253	\$ 591,229
Interest-bearing—Note G	<u>2,607,232</u>	<u>2,194,030</u>
Total deposits	3,258,485	2,785,259
Debt obligations:		
Notes payable and short-term borrowings—Note H	191,154	175,729
Subordinated debentures—Note I	<u>101,035</u>	<u>100,940</u>
Total debt obligations	292,189	276,669
Accrued interest on deposits and other liabilities	<u>26,751</u>	<u>28,089</u>
Total liabilities	3,577,425	3,090,017
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES—Note A	126,512	83,838
STOCKHOLDERS' EQUITY—Notes B, J and P		
Common stock, no par value, 50,000,000 shares authorized; issued and outstanding:		
2006 – 16,656,481 shares		
2005 – 15,776,192 shares	249,244	216,539
Retained earnings	112,779	85,553
Market value adjustment (net of tax effect) for investment securities available for sale (accumulated other comprehensive income/loss)	<u>(144)</u>	<u>(226)</u>
Total stockholders' equity	<u>361,879</u>	<u>301,866</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 4,065,816</u>	<u>\$ 3,475,721</u>

See notes to consolidated financial statements.

Consolidated Statements of Income

	-Year Ended December 31-		
	2006	2005	2004
	(in \$1,000s except per share data)		
Interest income:			
Portfolio loans (including fees)	\$ 264,701	\$ 214,882	\$ 173,376
Loans held for sale	2,740	2,627	2,150
Taxable investment securities	956	1,008	1,331
Federal funds sold	8,703	4,734	1,620
Other	<u>2,253</u>	<u>1,188</u>	<u>612</u>
Total interest income	279,353	224,439	179,089
Interest expense:			
Deposits	88,629	53,213	36,695
Debt obligations and other	<u>16,957</u>	<u>14,366</u>	<u>10,801</u>
Total interest expense	<u>105,586</u>	<u>67,579</u>	<u>47,496</u>
Net interest income	173,767	156,860	131,593
Provision for loan losses—Note D	<u>12,156</u>	<u>10,960</u>	<u>12,708</u>
Net interest income after provision for loan losses	161,611	145,900	118,885
Noninterest income:			
Service charges on deposit accounts	4,318	4,120	4,381
Trust and wealth-management revenue	3,336	2,069	3,456
Fees from origination of non-portfolio residential mortgage loans	5,439	6,146	5,581
Gains on sale of government-guaranteed loans	2,434	2,980	3,778
Realized gains (losses) on sales of investment securities available for sale		8	(603)
Other	<u>6,005</u>	<u>5,725</u>	<u>2,659</u>
Total noninterest income	21,532	21,048	19,252
Noninterest expense:			
Salaries and employee benefits	85,196	72,387	63,281
Occupancy	12,116	9,735	8,791
Equipment rent, depreciation and maintenance	8,389	6,369	5,494
Other	<u>32,103</u>	<u>28,798</u>	<u>20,221</u>
Total noninterest expense	<u>137,804</u>	<u>117,289</u>	<u>97,787</u>
Income before income taxes and minority interest	45,339	49,659	40,350
Income taxes—Note L	<u>15,463</u>	<u>19,232</u>	<u>14,699</u>
Income before minority interest	29,876	30,427	25,651
Minority interest in net losses of consolidated subsidiaries	<u>12,515</u>	<u>5,498</u>	<u>1,065</u>
NET INCOME	<u>\$ 42,391</u>	<u>\$ 35,925</u>	<u>\$ 26,716</u>
NET INCOME PER SHARE—Note M:			
Basic	<u>\$ 2.69</u>	<u>\$ 2.42</u>	<u>\$ 1.88</u>
Diluted	<u>\$ 2.57</u>	<u>\$ 2.34</u>	<u>\$ 1.79</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)	Total
Balances at January 1, 2004	\$ 175,962	\$ 43,135	\$ (200)	\$ 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 interests 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 unvested shares of restricted common stock, net of related unearned employee compensation	--			--
Recognition of compensation expense relating to restricted common stock of \$1,168 and other	820			820
Cash dividends paid (\$0.65 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	191,719	60,476	(36)	252,159
Issuance of 610,383 shares of common stock to acquire minority interests in subsidiaries	20,136			20,136
Issuance of 337,059 shares of common stock upon exercise of stock options, net of common stock surrendered to facilitate exercise	2,510			2,510
Recognition of compensation expense relating to restricted common stock of \$1,242 and other	1,590			1,590
Issuance of shares to ESOP	584			584
Cash dividends paid (\$0.72 per share)		(10,848)		(10,848)
Components of comprehensive income:				
Net income for 2005		35,925		35,925
Market value adjustment for investment securities available for sale (net of income tax effect)			(190)	(190)
Comprehensive income for 2005				<u>35,735</u>
BALANCES AT DECEMBER 31, 2005	216,539	85,553	(226)	301,866
Issuance of 555,280 shares of common stock to acquire minority interest in subsidiaries	24,962			24,962
Issuance of 244,259 shares of common stock upon exercise of stock options, net of common stock surrendered to facilitate exercise	3,573			3,573
Issuance of 80,750 unvested shares of restricted common stock, net of related unearned employee compensation	--			--
Recognition of compensation expense relating to restricted common stock	1,689			1,689
Tax benefit from share-based payments	2,481			2,481
Cash dividends paid (\$0.95 per share)		(15,165)		(15,165)
Components of comprehensive income:				
Net income for 2006		42,391		42,391
Market value adjustment for investment securities available for sale (net of income tax effect)			82	82
Comprehensive income for 2006				<u>42,473</u>
BALANCES AT DECEMBER 31, 2006	\$ 249,244	\$ 112,779	\$ (144)	\$ 361,879

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

	-Year Ended December 31-		
	2006	2005 (in \$1,000s)	2004
OPERATING ACTIVITIES			
Net income	\$ 42,391	\$ 35,925	\$ 26,716
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	12,156	10,960	12,708
Depreciation of premises and equipment	7,219	5,661	4,881
Amortization of intangibles	585	577	549
Net amortization (accretion) of investment security premiums (discounts)	(8)	63	87
Loss on sales of premises and equipment	18	157	111
Minority interest in net losses of consolidated subsidiaries	(12,515)	(5,498)	(1,065)
Compensation expense relating to restricted common stock	1,689	1,242	1,168
Deferred federal income tax credit	(5,493)	(5,263)	(2,282)
Originations and purchases of loans held for sale	(483,850)	(634,362)	(715,238)
Proceeds from sales of loans held for sale	470,895	655,867	715,096
Increase in accrued interest income and other assets	(17,504)	(15,815)	(5,475)
Increase (decrease) in accrued interest expense on deposits and other liabilities	(1,338)	11,801	347
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>14,245</u>	<u>61,315</u>	<u>37,603</u>
INVESTING ACTIVITIES			
Cash and cash equivalents of acquired subsidiary		3,557	4,202
Proceeds from sales of investment securities available for sale		1,756	59,574
Proceeds from calls, prepayments and maturities of investment securities	14,266	11,249	18,254
Purchases of investment securities	(9,347)	(14,667)	(19,736)
Net increase in portfolio loans	(504,790)	(306,258)	(403,358)
Proceeds from sales of premises and equipment	708	93	23
Purchases of premises and equipment	(20,611)	(14,879)	(11,139)
NET CASH USED BY INVESTING ACTIVITIES	<u>(519,774)</u>	<u>(319,149)</u>	<u>(352,180)</u>
FINANCING ACTIVITIES			
Net increase in demand deposits, NOW accounts and savings accounts	134,250	85,385	151,512
Net increase in certificates of deposit	338,976	189,802	16,354
Net borrowings from debt obligations	15,425	3,195	77,900
Net proceeds from issuance of subordinated debentures			9,935
Resources provided by minority interests	68,751	62,794	14,778
Net proceeds from issuance of common stock	3,573	2,510	954
Tax benefit from share-based payments	2,481		
Cash dividends paid	(15,165)	(10,848)	(9,375)
NET INCREASE PROVIDED BY FINANCING ACTIVITIES	<u>548,291</u>	<u>332,838</u>	<u>262,058</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>42,762</u>	<u>75,004</u>	<u>(52,519)</u>
Cash and cash equivalents at beginning of year	<u>306,108</u>	<u>231,104</u>	<u>283,623</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 348,870</u>	<u>\$ 306,108</u>	<u>\$ 231,104</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 located in the Eastern Regions consist of the following:

Affiliate	Location	Percentage Owned at December 31, 2006	Year Formed or Acquired
<i>Eastern Regions</i>			
<i>Great Lakes Region:</i>			
Ann Arbor Commerce Bank	Ann Arbor, Michigan	100%	1990
Bank of Auburn Hills	Auburn Hills, Michigan	(1)	2005
Bank of Belleville	Belleville, Illinois	(1)	2005
Bank of Maumee	Maumee, Ohio	(1)	2006
Bank of Michigan	Farmington Hills, Michigan	(1)	2005
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
Evansville Commerce Bank	Evansville, Indiana	(1)	2006
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
Ohio Commerce Bank	Beachwood, Ohio	(1)	2006
Paragon Bank & Trust	Holland, Michigan	100%	1994
Portage Commerce Bank	Portage, Michigan	100%	1988
Midwest Region – Summit Bank of Kansas City	Lee's Summit, Missouri	(1)	2005
<i>Southeast Region:</i>			
Bank of Valdosta	Valdosta, Georgia	(1)	2006
Community Bank of Rowan	Salisbury, North Carolina	(1)	2006
First Carolina State Bank	Rocky Mount, North Carolina	100%	2004
Peoples State Bank	Jeffersonville, Georgia	100%	2005
Sunrise Bank of Atlanta	Atlanta, Georgia	(1)	2006

(1) Majority-owned by a bank development subsidiary in which Capitol has a controlling interest.

Consolidated bank subsidiaries located in the Western Regions appear on the following page.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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

Consolidated bank subsidiaries – continued:

Affiliate	Location	Percentage Owned at December 31, 2006	Year Formed or Acquired
<i>Western Regions</i>			
Southwest Region:			
1 st Commerce Bank	North Las Vegas, Nevada	(1)	2006
Arrowhead Community Bank	Glendale, Arizona	100%	2000
Asian Bank of Arizona	Phoenix, Arizona	(1)	2006
Bank of Las Vegas	Las Vegas, Nevada	100%	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
Fort Collins Commerce Bank	Fort Collins, Colorado	51%	2005
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:			
Bank of Escondido	Escondido, California	100%	2003
Bank of San Francisco	San Francisco, California	51%	2005
Bank of Santa Barbara	Santa Barbara, California	(1)	2005
Napa Community Bank	Napa, California	87%	2002
Point Loma Community Bank	Point Loma, California	51%	2004
Sunrise Bank of San Diego	San Diego, California	100%	2001
Northwest Region:			
Bank of Bellevue	Bellevue, Washington	(1)	2005
Bank of Everett	Everett, Washington	(1)	2006

(1) Majority-owned by a bank development subsidiary in which Capitol has a controlling interest.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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

Capitol has formed several bank-development subsidiaries, 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, ranging from \$9.9 million to \$15.8 million for each of the bank-development companies, was sold in private offerings to accredited investors, some of whom are related parties of Capitol. These entities are engaged in bank development activities, through Capitol, either on a *de novo* basis or through acquisition opportunities. Each of these entities bear a similar name, Capitol Development Bancorp Limited ("CDBL"), numbered in their sequential formation, CDBL-I through CDBL-VI. CDBL-I became wholly-owned by Capitol effective November 30, 2006 (see Note R).

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's common stock. Capitol has made similar exchange proposals regarding the minority interests of some of its prior bank-development company subsidiaries which, after the share exchange, were merged with and into Capitol. 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. Capitol's bank affiliates provide a full range of banking services to individuals, businesses and other customers located in the respective communities of the bank. Many 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 financial needs of entrepreneurs, professionals and other businesses and individuals. A variety of deposit products are offered, including checking, savings, money market, certificates of deposit and individual retirement accounts. In addition, trust and investment services are offered through Paragon Bank & Trust. In late 2005, a wealth management subsidiary was established to pursue and deliver wealth management services to Capitol's banks. The principal markets for the banks' financial services are 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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

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, services and economic characteristics. 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 and/or controlled subsidiaries, after elimination of intercompany accounts and transactions, and after giving effect to applicable minority interests. Banks formed or acquired during 2004, 2005 and 2006 are included in the consolidated financial statements for periods after joining the consolidated group. Certain 2005 and 2004 amounts have been reclassified to conform to the 2006 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 Sale: Loans held for sale represent residential real estate mortgage loans held for sale into the secondary market. Loans held for sale are stated at the aggregate lower of cost or market. Fees from the origination of loans held for sale 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 and less significant concentrations exist in loans secured by 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. These obligations generally expire within one year and require collateral and/or personal guarantees based on management's credit assessment. The

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

maximum credit risk 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.

Credit risk also arises from amounts of funds on deposit at other financial institutions (i.e., due from banks) to the extent balances exceed the limits of federal deposit insurance. Capitol monitors the financial position of such financial institutions to evaluate credit risk periodically.

Interest and Fees on Loans: Interest income on loans is recognized based upon the principal balance of loans outstanding. Direct costs of successful origination of portfolio loans generally exceed fees from loan originations (approximately \$8.1 million of net deferred costs as of December 31, 2006). The fourth quarter of 2006 was favorably impacted by year-end adjustments, primarily driven by loan fees, approximating \$1.3 million net of income taxes.

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.

Premises and Equipment: Premises and equipment are stated on the basis of cost. Depreciation, which relates primarily to equipment, furniture and software 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 shorter of the respective lease term or estimated useful life.

Goodwill and Other Intangibles: Goodwill is reviewed annually by management for impairment by comparing estimated entity fair value to net assets of the entity. This review is performed at the applicable subsidiary reporting-unit level which has recorded goodwill resulting from specific share-exchange transactions (see Note R) or acquisitions. Impairment adjustments of goodwill (none through December 31, 2006) are charged against earnings, when determined. Other intangibles, which generally consist of core deposit intangibles, are amortized over varying periods of 5 years or less and are not material.

Other Real Estate: Other real estate (included as a component of other assets and which, at December 31, 2006 and 2005, approximated \$9.5 million and \$3.7 million, 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

fair value (net of estimated selling cost) at the date acquired and are periodically reviewed for subsequent changes in fair value.

Stock-Based Compensation: No stock-based compensation expense has been recorded upon granting of options to acquire common stock through December 31, 2006, because such stock options were accounted for under the provisions of Accounting Principles Board (APB) Opinion 25 (and related interpretations), when applicable, and were granted at an exercise price equal to the market price of common stock at grant date (such stock options were granted prior to 2006 and became fully vested at December 31, 2005 in advance of a new accounting standard applicable to stock options). Stock options state a specific exercise price and expiration date and may be exercised by the optionee upon payment of the exercise price and related taxes due from the optionee; the Corporation, in its discretion, may permit cashless exercises of stock options. Generally, previously unissued shares of common stock are issued upon exercise of stock options. Compensation expense for awards of restricted stock is recognized ratably over the vesting periods of such awards (generally ranging from four years to fifteen years), based on the fair value of the common stock on the date of grant.

Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, requires the fair value method of accounting for stock options whereby compensation expense will be recognized based on the computed fair value of the options on the grant date for stock options granted on or after the effective date of the standard, January 1, 2006. Certain pro forma disclosures of the expense recognition provisions of Statement No. 123(R) are required for periods prior to implementation of the standard for companies, such as Capitol, which used the intrinsic-value method for accounting for stock options, and are as follows for the years ended December 31, 2005 and 2004:

	2005	2004
Fair value assumptions:		
Risk-free interest rate	4.2%	3.9%
Dividend yield	2.0%	2.3%
Stock price volatility	.30	.25
Expected option life	6.8 years	6.7 years
Aggregate estimated fair value of options granted (in thousands)	\$ 9,373	\$ 6,581
Net income (in thousands):		
As reported	35,925	26,716
Pro forma	29,833	21,450
Net income per share:		
Basic:		
As reported	2.42	1.88
Pro forma	2.01	1.51
Diluted:		
As reported	2.34	1.79
Pro forma	\$ 1.94	\$ 1.44

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

Stock price volatility used in the valuation model was based on historical volatility. The risk-free interest rate was based on the yield of U.S. government securities with a maturity date that coincides with the expected option life. The expected option life was estimated based on past exercise behavior of optionees and the related option term.

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 and wealth management revenue are recorded on the accrual method.

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: On January 1, 2006, Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, became effective for Capitol. It 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 subject to Statement No. 123(R) 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 standard has been applied at Capitol using the modified-prospective method to stock options granted or modified after December 31, 2005 and any unvested stock options at that date. Capitol had no unvested stock options outstanding at December 31, 2005.

The primary effect of the revised standard's implementation on Capitol was recognition of compensation expense associated with stock options granted after December 31, 2005 (none were granted in 2006). Previously, Capitol 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. An additional change in accounting resulting from the implementation of Statement No. 123(R) is the reclassification of unvested restricted

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

stock to the common stock account on Capitol's balance sheet at January 1, 2006; such reclassification has also been reflected in the accompanying consolidated balance sheet as of December 31, 2005.

In late 2005, the FASB's staff issued Staff Position (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This FSP provides additional guidance on when an investment in a debt or equity security should be considered impaired and when that impairment should be considered other-than-temporary and recognized as a loss. Additionally, the FSP requires certain disclosures about unrealized losses which have not been recognized as other-than-temporary. The effect of this guidance did not have a material effect on Capitol's consolidated financial statements upon implementation on January 1, 2006.

In March 2006, the FASB issued Statement No. 156, *Accounting for Servicing of Financial Assets*, which is an amendment of Statement No. 140, intended to simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Statement No. 156 is effective for years beginning after September 15, 2006, although earlier adoption is permitted. The effect of the standard's adoption is not expected to be material upon implementation on January 1, 2007.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for how companies should recognize, measure, present and disclose in their financial statements uncertain tax positions taken or expected to be taken in a tax return. Under FIN 48, tax positions are recognized in the financial statements when it is more-likely-than-not the position will be sustained upon examination by the tax authorities. Such tax positions will be measured initially and thereafter as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement, presuming the tax authority has full knowledge of the position and all relevant facts. FIN 48 also revises disclosure requirements to include disclosure of unrecognized tax benefits. The provisions of this interpretation are required to be adopted for fiscal periods beginning after December 15, 2006. Companies are required to apply the provisions of FIN 48 to all tax positions upon initial adoption with any amounts relating to prior periods recorded as an adjustment to retained earnings. Capitol's management has, based on its preliminary review of the new guidance, estimated that the effect of adoption of FIN 48 will not be material to Capitol's consolidated financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*, which provides a definition of fair value for accounting purposes, establishes a framework for measuring fair value, expands related financial statement disclosures and will be effective for Capitol in 2008. Capitol's management has not completed its review of this new standard.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB No. 108) on quantifying financial statement misstatements. In summary, SAB No. 108 was issued to address the diversity in practice of evaluating and quantifying financial statement misstatements and the related accumulation of such misstatements. SAB No. 108 states that both a balance sheet approach and an income statement approach should be used when quantifying and evaluating the materiality of a potential misstatement and contains guidance for correcting errors under this dual perspective. SAB No. 108 became effective for Capitol's financial statements for the year ended December 31, 2006. The adoption of SAB No. 108 did not have a significant impact on Capitol's consolidated financial statements.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to choose to measure, on an item-by-item basis, specified financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected are required to be reported in earnings at each reporting date. Statement No. 159 will be applied prospectively and implemented by Capitol effective January 1, 2008. Management has not completed its analysis of this new standard.

Also recently, the FASB has issued several proposals to amend, supersede or interpret existing accounting standards which may impact Capitol's financial statements at a later date:

- Proposed amendment to Statement No. 128, *Earnings per Share*;
- Proposed replacement of Statement No. 141 regarding *Business Combinations*; and
- Proposed replacement of Accounting Research Bulletin No. 51 regarding *Consolidated Financial Statements, Including Accounting and Reporting for Noncontrolling Interests*.

Other proposals, interpretations of existing pronouncements or FASB staff positions have recently been issued which include the following:

- FASB FSP to require recalculation of leveraged leases if the timing of tax benefits affects cash flows;
- EITF Issue No. 06-4 which addresses accounting for deferred compensation and post retirement benefits of endorsement split-dollar life insurance; and

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

- EITF Issue No. 06-5 which encompasses accounting for purchases of life insurance and the ramifications of determining the amount that could be realized in accordance with FASB Technical Bulletin 84-4.

Capitol's management has not completed its analysis of this new guidance (as proposed, where applicable) although it anticipates the potential impact (if finalized, where applicable) would not be material to Capitol's consolidated financial statements.

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):

	2006		2005	
	Amortized Cost	Estimated Market Value	Amortized Cost	Estimated Market Value
Available for sale:				
United States government agency securities	\$ 13,403	\$ 13,285	\$ 23,276	\$ 23,022
Mortgage backed securities	4,089	3,991	2,430	2,348
Municipals	<u>1,630</u>	<u>1,628</u>	<u>568</u>	<u>559</u>
	19,122	18,904	26,274	25,929
Held for long-term investment:				
Federal Reserve Bank stock	864	864	536	536
Federal Home Loan Bank stock	14,148	14,148	12,960	12,960
Mortgage backed securities	--	--	7	7
Municipals	--	--	1,072	1,072
Corporate stock	4,419	4,419	1,835	1,835
Other	<u>2,318</u>	<u>2,318</u>	<u>1,335</u>	<u>1,335</u>
	<u>21,749</u>	<u>21,749</u>	<u>17,745</u>	<u>17,745</u>
	<u>\$ 40,871</u>	<u>\$ 40,653</u>	<u>\$ 44,019</u>	<u>\$ 43,674</u>

At December 31, 2006, securities with a market value approximating \$10 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE C—INVESTMENT SECURITIES—Continued

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

	2006		2005	
	Gains	Losses	Gains	Losses
United States government agency securities	\$ --	\$ 118	\$ 35	\$ 289
Mortgage backed securities	13	111	--	82
Municipals	11	13	4	13
	<u>\$ 24</u>	<u>\$ 242</u>	<u>\$ 39</u>	<u>\$ 384</u>

The age of gross unrealized losses and carrying value (at estimated market value) of securities available for sale are summarized below (in \$1,000s):

	2006		2005	
	Unrealized Loss	Carrying Value	Unrealized Loss	Carrying Value
One year or less:				
United States government agency securities	\$ 7	\$ 3,488	\$ 129	\$ 8,744
Mortgage backed securities	--	--	82	2,340
Municipals	--	--	13	242
	<u>\$ 7</u>	<u>\$ 3,488</u>	<u>\$ 224</u>	<u>\$ 11,326</u>
In excess of one year:				
United States government agency securities	\$ 111	\$ 9,297	\$ 160	\$ 12,595
Mortgage backed securities	111	3,444	--	--
Municipals	13	231	--	--
	<u>235</u>	<u>12,972</u>	<u>160</u>	<u>12,595</u>
	<u>\$ 242</u>	<u>\$ 16,460</u>	<u>\$ 384</u>	<u>\$ 23,921</u>

Management does not believe any individual unrealized loss as of December 31, 2006 represents other-than-temporary losses (primarily due to such amounts being attributable to changes in interest rates) 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE C—INVESTMENT SECURITIES—Continued

Scheduled maturities of investment securities held as of December 31, 2006 were as follows (in \$1,000s):

	Amortized Cost	Estimated Market Value
Due in one year or less	\$ 5,243	\$ 5,222
After one year, through five years	6,677	6,612
After five years, through ten years	3,961	3,900
After ten years	3,241	3,170
Securities held for long-term investment, without standard maturities	<u>21,749</u>	<u>21,749</u>
	<u>\$ 40,871</u>	<u>\$ 40,653</u>

NOTE D—LOANS

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

	2006	2005
Commercial	\$ 3,103,125	\$ 2,688,361
Real estate mortgage	259,604	212,142
Installment	<u>125,949</u>	<u>90,686</u>
Total portfolio loans	3,488,678	2,991,189
Less allowance for loan losses	<u>(45,414)</u>	<u>(40,559)</u>
Net portfolio loans	<u>\$ 3,443,264</u>	<u>\$ 2,950,630</u>

Loans serviced for the benefit of others, which are not recorded on the consolidated balance sheet, approximated \$92 million and \$77 million at December 31, 2006 and 2005, respectively.

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

	2006	2005	2004
Balance at January 1	\$ 40,559	\$ 37,572	\$ 31,404
Allowance for loan losses of acquired bank subsidiary	--	--	724
Provision charged to operations	12,156	10,960	12,708
Loans charged off (deduction)	(8,699)	(9,643)	(8,388)
Recoveries	<u>1,398</u>	<u>1,670</u>	<u>1,124</u>
Net charge-offs	<u>(7,301)</u>	<u>(7,973)</u>	<u>(7,264)</u>
Balance at December 31	<u>\$ 45,414</u>	<u>\$ 40,559</u>	<u>\$ 37,572</u>

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), which are a subset of nonperforming loans, were not material.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE D—LOANS—Continued

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	
	2006	2005
Nonaccrual loans:		
Commercial	\$ 25,219	\$ 19,734
Real estate mortgage	3,609	1,734
Installment	<u>898</u>	<u>1,154</u>
Total nonaccrual loans	29,726	22,622
Past due (>90 days) loans:		
Commercial	3,860	3,235
Real estate mortgage	523	592
Installment	<u>165</u>	<u>283</u>
Total past due loans	<u>4,548</u>	<u>4,110</u>
Total nonperforming loans	<u>\$ 34,274</u>	<u>\$ 26,732</u>

If nonperforming loans had performed in accordance with their contractual terms during the year, additional interest income of \$2.3 million, \$1.9 million and \$1.6 million would have been recorded in 2006, 2005 and 2004, respectively. Interest income recognized on loans in nonaccrual status in 2006, 2005 and 2004 operations approximated \$888,000, \$845,000 and \$714,000, respectively. At December 31, 2006, 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, 2006		December 31, 2005	
	Amount	Percentage of Total Portfolio Loans	Amount	Percentage of Total Portfolio Loans
Commercial	\$ 41,178	1.18%	\$ 37,498	1.26%
Real estate mortgage	2,675	0.08	1,866	0.06
Installment	<u>1,561</u>	<u>0.04</u>	<u>1,195</u>	<u>0.04</u>
Total allowance for loan losses	<u>\$ 45,414</u>	<u>1.30%</u>	<u>\$ 40,559</u>	<u>1.36%</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, 2006 and 2005, total loans to these persons were \$131 million and \$123 million, respectively. During 2006, \$127 million of new loans were made to these persons and repayments totaled \$119 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, which approximated \$171 million at December 31, 2006, are accepted based upon 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):

	2006	2005
Land, buildings and improvements	\$ 19,891	\$ 16,551
Leasehold improvements	19,483	14,631
Equipment, furniture and software	<u>45,734</u>	<u>35,875</u>
	85,108	67,057
Less accumulated depreciation	<u>(30,813)</u>	<u>(25,428)</u>
	<u>\$ 54,295</u>	<u>\$ 41,629</u>

Capitol and certain subsidiaries rent office space under operating leases. Rent expense (net of sublease income) under these lease agreements approximated \$7.6 million, \$6.2 million and \$5.9 million, respectively (including rent expense approximating \$1.5 million in 2006 and \$1.7 million in 2005 and 2004 under leases with related parties).

At December 31, 2006, 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):

2007	\$ 7,167
2008	6,406
2009	5,567
2010	4,895
2011	4,583
2012 and thereafter	<u>13,280</u>
	<u>\$ 41,898</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE G—DEPOSITS

The aggregate amount of time deposits of \$100,000 or more approximated \$960 million and \$702.9 million as of December 31, 2006 and 2005, respectively.

At December 31, 2006, the scheduled maturities of time deposits were as follows (in \$1,000s):

2007	\$ 1,153,331
2008	154,753
2009	50,231
2010	28,417
2011	30,865
2012 and thereafter	<u>2,636</u>
	<u>\$ 1,420,233</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>2006</u>	<u>2005</u>
Borrowings from Federal Home Loan Banks	\$ 183,598	\$ 172,736
Repurchase agreements	559	1,133
Federal funds purchased	<u>6,997</u>	<u>1,860</u>
	<u>\$ 191,154</u>	<u>\$ 175,729</u>

Borrowings from Federal Home Loan Banks (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 5% at December 31, 2006). At December 31, 2006, unused lines of credit under these facilities approximated \$379 million. Assets pledged to secure these credit facilities approximated \$423 million at December 31, 2006.

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 (8% at December 31, 2006), payable monthly, and a quarterly facility fee on the unused portion. There were no amounts drawn on the line of credit at December 31, 2006 or 2005. 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

For the periods presented, interest paid on debt obligations approximated amounts charged to expense.

At December 31, 2006, scheduled debt maturities of notes payable and short-term borrowings were as follows (in \$1,000s):

2007	\$ 125,314
2008	24,628
2009	8,500
2010	27,000
2011	5,594
2012 and thereafter	<u>118</u>
	<u>\$ 191,154</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:

	Interest Rate at December 31 2006	Scheduled Maturity	Aggregate Liquidation Amount (in \$1,000s)	Net Carrying Amount at December 31 (in \$1,000s)	
				2006	2005
Capitol Trust I	8.50% fixed	2027	\$ 25,300	\$ 24,543	\$ 24,507
Capitol Trust II	10.25% fixed	2031	10,000	9,753	9,743
Capitol Statutory Trust III	8.96% variable	2031	15,000	14,630	14,615
Capitol Trust IV	9.02% variable	2032	3,000	2,914	2,911
Capitol Trust VI	8.67% variable	2033	10,000	9,738	9,727
Capitol Trust VII	7.78% fixed	2033	10,000	9,866	9,861
Capitol Statutory Trust VIII	8.31% variable	2033	20,000	19,650	19,637
Capitol Trust IX	7.69% fixed	2034	<u>10,000</u>	<u>9,941</u>	<u>9,939</u>
			<u>\$ 103,300</u>	<u>\$ 101,035</u>	<u>\$ 100,940</u>

Securities of Capitol Trust I were issued in a 1997 public offering. All other Capitol Trust securities were subsequently formed in conjunction with private placements of trust-preferred securities. 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

Shares of restricted common stock have been granted to certain officers. Compensation expense related to restricted stock approximated \$1.7 million in 2006 and \$1.2 million in 2005 and 2004. Tax benefits associated with such compensation expense approximated \$351,000 in 2006 and \$229,000 in 2005 and 2004. Future compensation expense related to unvested restricted common stock as of December 31, 2006 approximates \$4.4 million (based on grants through December 31, 2006), to be recorded ratably over a period of approximately 3.2 years, based on the weighted-average remaining vesting period at that date.

Restricted share activity is summarized below:

	2006		2005		2004	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Unvested at January 1	200,631	\$ 21.76	258,978	\$ 21.91	259,017	\$ 21.76
Granted	80,750	38.69	--	--	13,063	28.86
Vested	56,965	22.27	58,347	22.43	13,102	25.92
Forfeited	--	--	--	--	--	--
Unvested at December 31	<u>224,416</u>	<u>\$ 27.72</u>	<u>200,631</u>	<u>\$ 21.76</u>	<u>258,978</u>	<u>\$ 21.91</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE J—RESTRICTED COMMON STOCK AND STOCK OPTIONS—Continued

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, 2004	2,298,067	\$ 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	<u>(32,739)</u>		
Outstanding at December 31, 2004	2,584,139	10.81 to 33.01	21.06
Granted in 2005	929,425	30.21 to 37.48	33.96
Exercised in 2005	(589,943)	11.00 to 30.21	15.94
Cancelled or expired in 2005	<u>(41,338)</u>		
Outstanding at December 31, 2005	2,882,283	10.81 to 37.48	26.07
Granted in 2006	--		
Exercised in 2006	(312,192)	10.81 to 37.48	19.59
Cancelled or expired in 2006	<u>--</u>		
Outstanding at December 31, 2006	<u>2,570,091</u>	\$10.81 to \$37.48	<u>\$26.86</u>

The aggregate intrinsic value of exercised options approximated \$8.3 million, \$12.7 million and \$10 million in 2006, 2005 and 2004, respectively.

As of December 31, 2006, all outstanding stock options were vested, currently exercisable and had a weighted average remaining contractual life of 3.94 years. The following table summarizes stock options outstanding segregated by exercise price range:

Exercise Price Range	Number Outstanding	Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
\$10.00 to 14.99	142,033	\$11.28	0.61 years	\$ 4,959,792
\$15.00 to 19.99	279,493	16.62	2.83 years	8,267,403
\$20.00 to 24.99	458,868	21.68	3.81 years	11,251,443
\$25.00 to 29.99	643,267	27.00	3.39 years	12,350,726
\$30.00 to 34.99	697,643	32.11	4.69 years	9,829,790
\$35.00 or more	<u>348,787</u>	37.48	5.86 years	<u>3,041,423</u>
	<u>2,570,091</u>			<u>\$49,700,577</u>

Cash received upon exercise of stock options approximated \$5.1 million, \$4.2 million and \$2.4 million and tax benefits realized approximated \$2.1 million, \$1.8 million and \$908,000 in 2006, 2005 and 2004, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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, a partial match based on employee contributions (50%, subject to certain limitations), charged to expense for the years ended December 31, 2006, 2005 and 2004 were \$1.5 million, \$1.1 million and \$1.0 million, respectively.

Capitol also has a defined contribution employee stock ownership plan (ESOP) which covers substantially all employees of Capitol and certain subsidiaries. ESOP contributions charged to expense in 2006, 2005 and 2004 approximated \$1,134,000, \$949,000 and \$961,000, respectively. As of December 31, 2006, the ESOP held approximately 292,000 shares of Capitol's common stock which have been allocated to participants' accounts; there were no unallocated shares as of that date.

NOTE L—INCOME TAXES

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

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal:			
Currently payable	\$ 21,367	\$ 22,326	\$ 15,401
Deferred (credit)	<u>(5,493)</u>	<u>(5,263)</u>	<u>(2,282)</u>
	15,874	17,063	13,119
State income taxes (credit)	<u>(411)</u>	<u>2,169</u>	<u>1,580</u>
	<u>\$ 15,463</u>	<u>\$ 19,232</u>	<u>\$ 14,699</u>

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 million in 2006, 2005 and 2004, and is excluded from income tax expense (included as a component of other noninterest expense).

Federal income taxes paid in 2006, 2005 and 2004 approximated \$20.9 million, \$19.3 million and \$17.1 million, respectively. State income taxes approximating \$1.8 million were paid in 2006 (\$1.9 million in 2005 and \$1.6 million in 2004). Federal income taxes payable at December 31, 2006 and 2005 were reduced by tax benefits approximating \$2.1 million and \$1.8 million, respectively, arising from the exercise of stock options.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE L—INCOME TAXES—Continued

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

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal income tax computed at statutory rate of 35%	\$ 15,869	\$ 17,381	\$ 14,122
State income taxes (credit)	(411)	2,169	1,580
Federal tax effect of:			
Amortization of intangibles	205	202	192
State income taxes	144	(759)	(553)
Other	(344)	239	(642)
	<u>\$ 15,463</u>	<u>\$ 19,232</u>	<u>\$ 14,699</u>

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

	<u>2006</u>	<u>2005</u>
Allowance for loan losses	\$ 15,099	\$ 13,186
Net operating losses of subsidiaries	8,202	3,774
Deferred compensation	2,635	2,395
Depreciation	(2,136)	(1,944)
Start-up costs for <i>de novo</i> banks	2,730	1,301
Market value adjustment for investment securities available for sale	74	117
Other, net	(1,629)	696
	<u>\$ 24,975</u>	<u>\$ 19,525</u>

Certain subsidiaries have net operating loss carryforwards which may reduce income taxes payable in future periods, which have been recognized for financial reporting purposes and, as of December 31, 2006, expire at the following dates and amounts (in \$1,000s):

2024	\$ 2,545
2025	7,344
2026	<u>13,545</u>
	<u>\$ 23,434</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE M—NET INCOME PER SHARE

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

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Numerator—net income	<u>\$ 42,391</u>	<u>\$ 35,925</u>	<u>\$ 26,716</u>
Denominator:			
Weighted average number of shares outstanding, excluding unvested restricted shares (denominator for basic earnings per share)	15,772	14,867	14,183
Effect of dilutive securities:			
Unvested restricted shares	86	86	263
Stock options	<u>623</u>	<u>412</u>	<u>445</u>
Potential dilution	<u>709</u>	<u>498</u>	<u>708</u>
Denominator for diluted earnings per share—weighted average number of shares and potential dilution	<u>16,481</u>	<u>15,365</u>	<u>14,891</u>
Number of antidilutive stock options excluded from diluted earnings per share computation	<u>--</u>	<u>1,085</u>	<u>160</u>

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

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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):

	2006		2005	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 348,870	\$ 348,870	\$ 306,108	\$ 306,108
Loans held for sale	34,593	34,593	21,638	21,638
Investment securities:				
Available for sale	18,904	18,904	25,929	25,929
Held for long-term investment	<u>21,749</u>	<u>21,749</u>	<u>17,745</u>	<u>17,745</u>
	40,653	40,653	43,674	43,674
Portfolio loans:				
Commercial	3,103,125	3,093,134	2,688,361	2,680,149
Real estate mortgage	259,604	259,948	212,142	213,324
Installment	<u>125,949</u>	<u>121,775</u>	<u>90,686</u>	<u>90,091</u>
Total portfolio loans	3,488,678	3,474,857	2,991,189	2,983,564
Less allowance for loan losses	<u>(45,414)</u>	<u>(45,414)</u>	<u>(40,559)</u>	<u>(40,559)</u>
Net portfolio loans	3,443,264	3,429,443	2,950,630	2,943,005
Financial Liabilities:				
Deposits:				
Noninterest-bearing	651,253	651,253	591,229	591,229
Interest-bearing:				
Demand accounts	1,186,999	1,187,320	1,112,773	1,111,669
Time certificates of less than \$100,000	460,203	461,145	378,364	378,002
Time certificates of \$100,000 or more	<u>960,030</u>	<u>961,649</u>	<u>702,893</u>	<u>702,085</u>
Total interest-bearing	<u>2,607,232</u>	<u>2,610,114</u>	<u>2,194,030</u>	<u>2,191,756</u>
Total deposits	3,258,485	3,261,367	2,785,259	2,782,985
Notes payable and short-term borrowings				
Subordinated debentures	191,154	191,713	175,729	175,059
	101,035	103,300	100,940	103,300

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 (\$32.3 million and \$20.6 million outstanding at December 31, 2006 and 2005, respectively). Other loan commitments outstanding consist of unused lines of credit and approved, but unfunded, specific loan commitments (\$794 million and \$714.8 million at December 31, 2006 and 2005, 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, 2006 and 2005 was \$6.7 million.

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 (\$19.8 million at December 31, 2006).

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 judgments 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, 2006, 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, 2006, 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 Capitol's consolidated regulatory capital position:

	December 31	
	2006	2005
Tier 1 capital to average adjusted total assets:		
Minimum required amount	≥\$155,110	≥\$135,864
Actual amount	\$527,355	\$438,458
Ratio	13.60%	12.91%
Tier 1 capital to risk-weighted assets:		
Minimum required amount ⁽¹⁾	≥\$145,475	≥\$123,072
Actual amount	\$527,355	\$438,458
Ratio	14.50%	14.25%
Combined Tier 1 and Tier 2 capital to risk-weighted assets:		
Minimum required amount ⁽²⁾	≥\$290,949	≥\$246,144
Amount required to meet 'Well-Capitalized' category ⁽³⁾	≥\$363,687	≥\$307,680
Actual amount	\$572,816	\$476,944
Ratio	15.75%	15.50%

(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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE Q—PARENT COMPANY FINANCIAL INFORMATION

Condensed Balance Sheets

	-December 31-	
	2006	2005
	(in \$1,000s)	
Assets		
Cash on deposit principally with subsidiary banks	\$ 3,314	\$ 5,129
Money market funds on deposit principally with subsidiary banks	4,113	6,554
Time deposits principally with subsidiary banks	<u>10,406</u>	<u>14,747</u>
Cash and cash equivalents	17,833	26,430
Investment securities	4,048	673
Loans, net	11,314	2,865
Investments in and advances to subsidiaries	418,239	362,843
Investment in and advances to Amera Mortgage Corporation	482	482
Equipment, software and furniture, net	9,332	5,164
Other assets	<u>13,206</u>	<u>19,103</u>
 Total assets	 <u>\$ 474,454</u>	 <u>\$ 417,560</u>
Liabilities and Stockholders' Equity		
Accounts payable, accrued expenses and other liabilities	\$ 8,342	\$ 11,556
Subordinated debentures	<u>104,233</u>	<u>104,138</u>
Total liabilities	112,575	115,694
Stockholders' equity	<u>361,879</u>	<u>301,866</u>
 Total liabilities and stockholders' equity	 <u>\$ 474,454</u>	 <u>\$ 417,560</u>

Condensed Statements of Income

	-Year Ended December 31-		
	2006	2005	2004
	(in \$1,000s)		
Income			
Dividends from subsidiaries	\$ 30,475	\$ 34,350	\$ 16,075
Intercompany fees	23,039	19,458	16,561
Interest	199	816	468
Other	<u>943</u>	<u>1,413</u>	<u>99</u>
Total income	54,656	56,037	33,203
Expenses:			
Interest	8,896	7,976	6,931
Salaries and employee benefits	10,482	13,325	13,370
Occupancy	1,584	1,249	1,138
Amortization, equipment rent and depreciation	2,146	1,839	1,757
Other	<u>1,606</u>	<u>3,153</u>	<u>4,720</u>
Total expenses	<u>24,714</u>	<u>27,542</u>	<u>27,916</u>
Income before equity in undistributed net earnings of consolidated subsidiaries and income tax credit	29,942	28,495	5,287
Equity in undistributed net earnings of consolidated subsidiaries	<u>11,773</u>	<u>6,171</u>	<u>17,665</u>
Income before income tax credit	41,715	34,666	22,952
Income tax credit	<u>(676)</u>	<u>(1,259)</u>	<u>(3,764)</u>
 Net income	 <u>\$ 42,391</u>	 <u>\$ 35,925</u>	 <u>\$ 26,716</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-		
	2006	2005 (in \$1,000s)	2004
OPERATING ACTIVITIES			
Net income	\$ 42,391	\$ 35,925	\$ 26,716
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net earnings of subsidiaries	(11,773)	(6,171)	(17,665)
Depreciation and amortization of intangibles	1,459	1,245	1,197
Loss on sale of equipment and furniture	3	3	
Decrease in amounts due from subsidiaries and other assets	23,388	7,938	10,597
Increase (decrease) in accounts payable, accrued expenses and other liabilities	(3,214)	1,772	718
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>52,254</u>	<u>40,712</u>	<u>21,563</u>
INVESTING ACTIVITIES			
Net cash investments in subsidiaries	(36,193)	(31,723)	(27,887)
Net payments from Amera Mortgage Corporation		315	62
Purchases of investment securities	(2,000)	(673)	
Net increase in loans	(8,449)	(1,635)	(326)
Proceeds from sales of equipment and furniture		4	
Purchases of equipment and furniture	(5,098)	(4,034)	(662)
NET CASH USED BY INVESTING ACTIVITIES	<u>(51,740)</u>	<u>(37,746)</u>	<u>(28,813)</u>
FINANCING ACTIVITIES			
Net proceeds from issuance of common stock	3,573	2,510	954
Net proceeds from issuance of subordinated debentures			9,935
Tax benefit from share-based payments	2,481		
Cash dividends paid	(15,165)	(10,848)	(9,375)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	<u>(9,111)</u>	<u>(8,338)</u>	<u>1,514</u>
DECREASE IN CASH AND CASH EQUIVALENTS	<u>(8,597)</u>	<u>(5,372)</u>	<u>(5,736)</u>
Cash and cash equivalents at beginning of year	<u>26,430</u>	<u>31,802</u>	<u>37,538</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 17,833</u>	<u>\$ 26,430</u>	<u>\$ 31,802</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE R—ACQUISITION OF MINORITY INTERESTS AND ACQUISITION OF BANK

During 2006, two share-exchange transactions were completed which involved the issuance of previously unissued shares of Capitol's common stock in exchange for the minority interests of the following subsidiaries:

<u>Entity</u>	<u>Effective Date</u>	<u>Number of Common Shares Issued</u>
Bank of Escondido	December 31, 2006	189,000
Capitol Development Bancorp Limited I	November 30, 2006	366,000

Had these acquisitions occurred at the beginning of 2005, unaudited pro forma consolidated net income would have approximated \$42.3 million in 2006 and \$34.3 million in 2005 and diluted earnings per share would have been \$2.49 in 2006 and \$2.16 in 2005. Each of these acquisitions has 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 \$25 million which resulted in the recording of goodwill of approximately \$11 million and acquisition of minority interests approximating \$14 million.

In April 2005, Capitol acquired a majority interest in Peoples State Bank ("Peoples") located in Jeffersonville, Georgia, in a purchase transaction with total consideration approximating \$2.2 million. Peoples' total assets approximated \$22.9 million at the acquisition date, including \$1.2 million of goodwill relating to the purchase of the controlling interest in the bank by Capitol. Capitol's acquisition of Peoples 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. The pro forma effect of this acquisition was not significant.

During 2005, three share-exchange transactions were also completed, whereby certain previously majority-owned consolidated subsidiaries became wholly-owned:

<u>Entity</u>	<u>Effective Date</u>	<u>Number of Common Shares Issued</u>
Napa Community Bank	August 31, 2005	202,000
Bank of Las Vegas	November 30, 2005	179,000
First California Southern Bancorp	December 31, 2005	229,000

Had these acquisitions occurred at the beginning of 2004, unaudited pro forma consolidated net income would have approximated \$36.2 million in 2005 and \$26.7 million in 2004, and diluted earnings per share would have been \$2.28 in 2005 and \$1.72 in 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE S—PENDING SHARE EXCHANGE TRANSACTIONS

A share exchange proposal was pending at December 31, 2006 regarding Capitol Development Bancorp Limited II, which was subsequently approved by its shareholders. Capitol issued approximately 371,000 shares of previously unissued common stock upon completion of the share exchange in February 2007.

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