

FINANCIAL INFORMATION

Selected Consolidated Financial Data

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

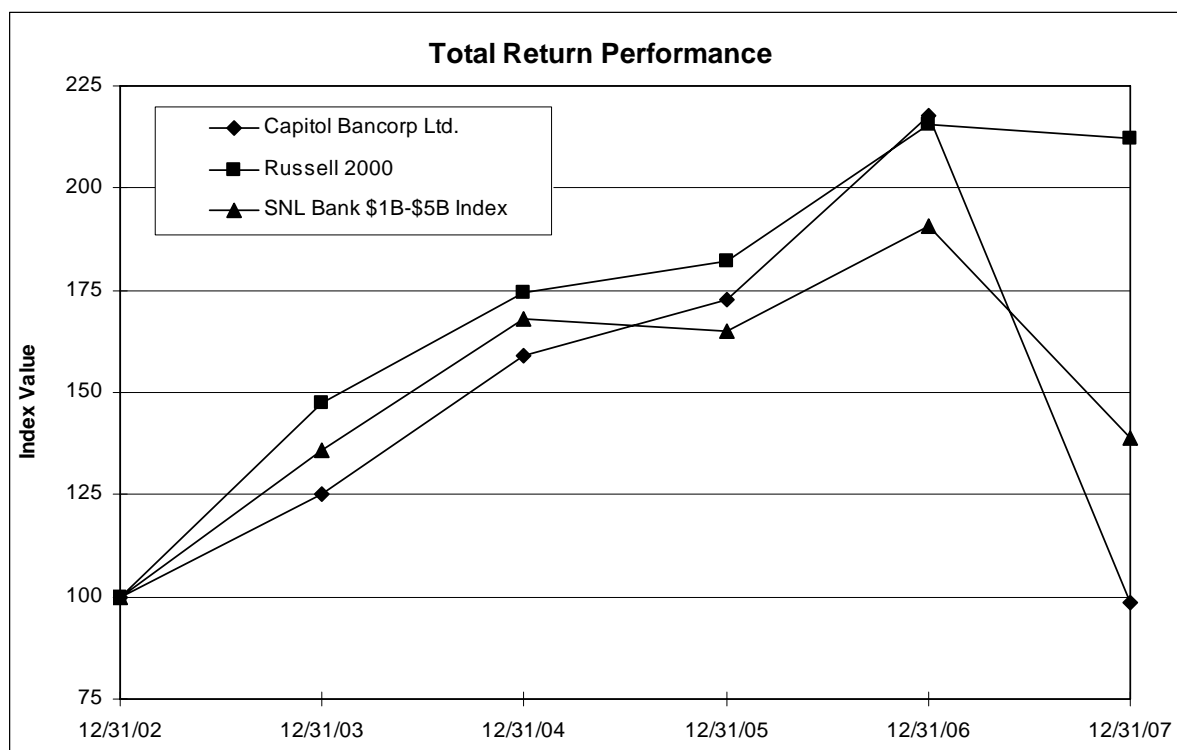
	As of and for the Year Ended December 31				
	2007 ⁽¹⁾	2006 ⁽²⁾	2005 ⁽³⁾	2004 ⁽⁴⁾	2003 ⁽⁵⁾
For the year:					
Interest income	\$ 330,439	\$ 279,353	\$ 224,439	\$ 179,089	\$ 164,416
Interest expense	147,162	105,586	67,579	47,496	49,490
Net interest income	183,277	173,767	156,860	131,593	114,926
Provision for loan losses	25,340	12,156	10,960	12,708	9,861
Noninterest income	24,381	21,532	21,048	19,252	20,087
Noninterest expense	176,160	137,804	117,289	97,787	86,952
Net income	21,937	42,391	35,925	26,716	23,380
Net income per share:					
Basic	1.29	2.69	2.42	1.88	1.86
Diluted	1.27	2.57	2.34	1.79	1.77
Cash dividends paid per share	1.00	.95	.72	.65	.51
At end of year:					
Total assets	\$ 4,901,763	\$ 4,065,816	\$ 3,475,721	\$ 3,091,418	\$ 2,737,062
Total earning assets	4,527,006	3,743,041	3,204,646	2,885,545	2,521,375
Portfolio loans	4,314,701	3,488,678	2,991,189	2,692,904	2,247,440
Deposits	3,844,745	3,258,485	2,785,259	2,510,072	2,288,664
Notes payable and short-term borrowings	320,384	191,154	175,729	172,534	92,774
Subordinated debentures	156,130	101,035	100,940	100,845	90,816
Minority interests in consolidated subsidiaries	156,198	126,512	83,838	39,520	30,946
Stockholders' equity	389,145	361,879	301,866	252,159	218,897
		Quarterly Results of Operations (unaudited)			
	Total for the Year	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Year ended December 31, 2007:⁽¹⁾					
Interest income	\$ 330,439	\$ 86,310	\$ 85,036	\$ 81,254	\$ 77,839
Interest expense	147,162	39,924	38,368	35,712	33,158
Net interest income	183,277	46,386	46,668	45,542	44,681
Provision for loan losses	25,340	9,528	7,890	3,990	3,932
Net income	21,937	3,394	5,974	6,298	6,271
Net income per share: ⁽⁷⁾					
Basic	1.29	.20	.35	.37	.38
Diluted	1.27	.20	.35	.37	.36
Cash dividends paid per share	1.00	.25	.25	.25	.25
Year ended December 31, 2006:⁽²⁾					
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: ⁽⁷⁾					
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
(1)	Includes Bank of Tacoma, effective January 2007 (located in Tacoma, Washington), Sunrise Community Bank, effective February 2007 (located in Palm Desert, California), Larimer Bank of Commerce, effective May 2007 (located in Fort Collins, Colorado), Issaquah Community Bank (located in Issaquah, Washington) and USNY Bank (located in Geneva, New York), both effective July 2007, High Desert Bank, effective September 2007 (located in Bend, Oregon), Loveland Bank of Commerce, effective October 2007 (located in Loveland, Colorado), Bank of Feather River, effective November 2007 (located in Yuba City, California) and Community Bank of Lincoln (located in Lincoln, Nebraska), Bank of Fort Bend (located in Sugar Land, Texas) and Bank of Las Colinas (located in Irving, Texas), each effective December 2007.				
(2)	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 1 st Commerce Bank (located in North Las Vegas, Nevada), both effective October 2006, and Ohio Commerce Bank (located in Beachwood, Ohio), effective November 2006.				
(3)	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).				
(4)	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.				
(5)	Includes Bank of Escondido (located in Escondido, California), effective October 2003.				
(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.				
(7)	Each period's computation of net income per share is performed independently and, accordingly, net income per share for the year (basic and diluted) may not equal the sum of the amounts shown for the quarterly periods.				

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:	2007		2006	
	Low	High	Low	High
March 31	\$ 36.81	\$ 47.06	\$ 36.74	\$ 47.22
June 30	27.06	37.60	37.84	47.16
September 30	20.00	27.86	36.89	46.00
December 31	18.15	27.24	44.12	47.49

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, 2002 and that subsequent cash dividends were reinvested.



Index	Period Ended					
	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07
CBC	100.00	125.08	158.81	172.55	217.72	98.54
R-2000	100.00	147.25	174.24	182.18	215.64	212.26
SNL	100.00	135.99	167.83	164.97	190.90	139.06

INFORMATION REGARDING CAPITOL'S COMMON STOCK--Continued

During 2007, Capitol paid quarterly cash dividends of \$0.25 per share. In 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. 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, 2008, there were 6,998 beneficial holders of Capitol's common stock, based on information supplied to Capitol from its stock transfer agent and other sources.

At February 25, 2008, 17,319,178 shares of common stock were outstanding. Capitol's stock transfer agent is Computershare Trust Company, N.A., 250 Royall Street, Canton, MA 02021 (telephone 800/884-4225). The web site for Computershare Trust Company, N.A. is <http://www.computershare.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 Capitol Bancorp Direct prospectus, informational brochure and enrollment materials, contact Computershare Trust Company, 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 the 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 (SEC) 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. Further, Capitol filed certifications by its CEO and CFO with the SEC in accordance with the Sarbanes-Oxley Act of 2002 as exhibits to Capitol's Form 10-K for the year ended December 31, 2007.

AVAILABILITY OF FORM 10-K AND CERTAIN OTHER REPORTS

A copy of Capitol's 2007 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 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 2008 Annual Meeting of Shareholders will be held on Wednesday, April 23, 2008 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

Computershare Trust Company, N.A.
250 Royall Street
Canton, MA 02021
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. Capitol Bancorp Direct'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 Capitol Bancorp Direct is voluntary and shareholders and prospective investors are eligible. Purchases under Capitol Bancorp Direct are not currently subject to any brokerage fees or commissions. For further information regarding Capitol Bancorp Direct or a copy of Capitol Bancorp Direct's prospectus, informational brochure and enrollment materials, contact Computershare Trust Company, N.A. at 800/884-4225 or Capitol at 517/487-6555.

SHAREHOLDER INFORMATION--Continued

TRUST-PREFERRED SECURITIES TRADING INFORMATION

Preferred securities of Capitol Trust I (a subsidiary of Capitol) trade on the 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 may constitute 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 60 banks operating in 17 states as of December 31, 2007. Capitol previously announced plans to expand to 100 banks within the next five years.

Capitol's *de novo* bank model is intended to create a scalable, low overhead structure which is focused on delivering return-on-equity results, while empowering its individual banks with operating autonomy in all areas which impact the customer relationship. Capitol's centralized '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.

2007 was another significant year of expansion:

- The addition of 11 new banks, the largest number in any year in Capitol's history, bringing the affiliation network total to 60 financial institutions at year-end 2007.
- Total assets surpassing \$4.9 billion at year end, marking a growth rate of 20.6% for the year.

Earnings decreased from \$42.4 million (\$2.57 per diluted share) in 2006 to \$21.9 million (\$1.27 per diluted share) in 2007, primarily due to weakened bank earnings performance in the Great Lakes Region.

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 has recognized from its beginning that its banking focus always has been, and always will be, a people business. 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. When a *de novo* bank achieves certain developmental milestones (age, cumulative profitability, return on equity or other measures), Capitol may offer 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, at a multiple of the bank's then current book value (typically 150%). 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 2007, Capitol completed one share-exchange transaction; two share-exchange transactions were completed in 2006.

Monitoring and Managing Capitol's Investments in Community Banks

The concept of *bank development* is not limited to starting and nurturing new banks. At Capitol, it also means nurturing middle-stage and mature bank affiliates to help them maximize their potential. Capitol monitors and manages its investments in community banks working through regional presidents, supported by Capitol's bank financial analysis group. Capitol's bank financial analysis group assists the banks in the development of detailed budgets, assisting with asset/liability management strategies, monitoring progress on the banks' business plans and reviewing monthly operating results for each bank. Capitol's regional presidents also assist in the identification of new 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.

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 regions are summarized below as of and for the years ended December 31, 2007 and 2006 (in \$1,000s):

	Total Assets		Total Revenues ⁽³⁾	
	2007	2006	2007	2006
Arizona Region:				
Arrowhead Community Bank	\$ 89,060	\$ 79,152	\$ 8,161	\$ 8,076
Asian Bank of Arizona ⁽²⁾	25,017	20,248	1,760	781
Bank of Tucson	187,468	187,683	16,000	15,358
Camelback Community Bank	84,671	83,003	6,780	6,355
Mesa Bank	217,861	201,776	19,685	19,000
Southern Arizona Community Bank	85,158	85,912	6,872	6,629
Sunrise Bank of Albuquerque	71,726	59,798	6,168	4,796
Sunrise Bank of Arizona	116,245	119,785	9,336	10,347
Valley First Community Bank	77,306	72,333	5,544	5,629
Yuma Community Bank	78,489	74,477	6,078	6,049
Arizona Region Total	1,033,001	984,167	86,384	83,020
California Region:				
Bank of Escondido	89,557	82,412	5,914	5,115
Bank of Feather River ⁽¹⁾	17,283		171	
Bank of San Francisco	68,902	28,122	3,250	1,649
Bank of Santa Barbara	58,738	42,559	4,282	2,138
Napa Community Bank	131,457	99,009	9,483	7,212
Point Loma Community Bank	56,428	43,715	4,161	3,185
Sunrise Bank of San Diego	81,905	71,170	7,092	5,800
Sunrise Community Bank ⁽¹⁾	21,113		1,099	
California Region Total	525,383	366,987	35,452	25,099
Colorado Region:				
Fort Collins Commerce Bank	61,083	54,410	4,696	3,641
Larimer Bank of Commerce ⁽¹⁾	51,906		2,199	
Loveland Bank of Commerce ⁽¹⁾	15,941		234	
Colorado Region Total	128,930	54,410	7,129	3,641
Great Lakes Region:				
Ann Arbor Commerce Bank	362,429	310,407	25,800	23,598
Bank of Auburn Hills	44,767	31,559	3,298	1,849
Bank of Maumee ⁽²⁾	35,576	9,915	1,552	133
Bank of Michigan	69,909	51,287	4,945	3,073
Brighton Commerce Bank	108,664	103,909	8,308	7,889
Capitol National Bank	228,556	256,741	17,794	17,531
Detroit Commerce Bank	113,243	106,233	9,083	8,634
Elkhart Community Bank	89,064	86,883	6,876	6,476
Evansville Commerce Bank ⁽²⁾	50,819	20,772	2,789	591
Goshen Community Bank	93,173	80,137	6,128	5,216
Grand Haven Bank	130,492	129,033	9,575	9,702
Kent Commerce Bank	87,060	86,916	6,545	6,800
Macomb Community Bank	93,045	101,353	6,666	7,713
Muskegon Commerce Bank	98,975	95,551	7,117	7,494
Oakland Commerce Bank	109,370	134,437	9,288	9,660
Ohio Commerce Bank ⁽²⁾	35,690	14,466	1,533	199
Paragon Bank & Trust	103,711	98,804	7,034	7,816
Portage Commerce Bank	189,944	179,413	15,479	14,813
Great Lakes Region Total	2,044,487	1,897,816	149,810	139,187
Midwest Region:				
Bank of Belleville	50,485	24,948	2,389	1,188
Community Bank of Lincoln ⁽¹⁾	12,960		65	
Summit Bank of Kansas City	50,142	19,529	3,452	841
Midwest Region Total	113,587	44,477	5,906	2,029

Summary of total assets and revenues – continued:

	Total Assets		Total Revenues ⁽³⁾	
	2007	2006	2007	2006
Nevada Region:				
1 st Commerce Bank ⁽²⁾	\$ 32,091	\$ 14,829	\$ 1,762	\$ 202
Bank of Las Vegas	72,768	67,478	5,966	5,331
Black Mountain Community Bank	147,433	138,961	12,282	10,984
Desert Community Bank	101,840	93,914	8,216	7,464
Red Rock Community Bank	120,750	108,362	9,319	8,515
Nevada Region Total	474,882	423,544	37,545	32,496
Northeast Region:				
USNY Bank ⁽¹⁾	17,171		438	
Northwest Region:				
Bank of Bellevue	45,122	33,155	3,152	2,061
Bank of Everett ⁽²⁾	28,946	20,061	1,907	489
Bank of Tacoma ⁽¹⁾	24,325		1,304	
High Desert Bank ⁽¹⁾	11,501		221	
Issaquah Community Bank ⁽¹⁾	13,696		330	
Northwest Region Total	123,590	53,216	6,914	2,550
Southeast Region:				
Bank of Valdosta ⁽²⁾	43,842	21,626	2,574	561
Community Bank of Rowan ⁽²⁾	117,495	45,503	6,195	1,870
First Carolina State Bank	115,243	93,819	7,556	6,341
Peoples State Bank	26,159	32,714	2,226	2,629
Sunrise Bank of Atlanta ⁽²⁾	48,664	16,990	3,922	912
Southeast Region Total	351,403	210,652	22,473	12,313
Texas Region:				
Bank of Ford Bend ⁽¹⁾	9,551		27	
Bank of Las Colinas ⁽¹⁾	11,383		37	
Texas Region Total	20,934		64	
Other, net ⁽⁴⁾	68,395	30,547	2,705	550
Consolidated Totals	<u>\$ 4,901,763</u>	<u>\$ 4,065,816</u>	<u>\$ 354,820</u>	<u>\$ 300,885</u>

- (1) Became a Capitol affiliate in 2007 and is included for periods after addition to the Capitol banking network.
- (2) Became a Capitol affiliate in 2006 and is included for periods after addition to the Capitol banking network.
- (3) Total revenues is the sum of interest income and noninterest income.
- (4) Includes corporate and other nonbank entities.

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Capitol's Results of Operations

Net income for 2007 approximated \$21.9 million, a 48% decrease from the \$42.4 million earned in 2006. Net income for 2005 was \$35.9 million. Diluted earnings per share for 2007 was \$1.27 compared to \$2.57 in 2006 and \$2.34 in 2005.

The table below summarizes, for Capitol's banks individually and regionally, 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		
	2007	2006	2005	2007	2006	2005	2007	2006	2005
Arizona Region:									
Arrowhead Community Bank	\$ 762	\$ 1,293	\$ 1,255	9.24%	15.68%	17.47%	0.89%	1.49%	1.56%
Asian Bank of Arizona ⁽²⁾	(507)	(567)							
Bank of Tucson	4,527	4,656	3,732	26.48%	29.93%	27.61%	2.52%	2.62%	2.12%
Camelback Community Bank	992	1,119	1,167	11.14%	13.64%	13.90%	1.13%	1.36%	1.42%
Mesa Bank	3,983	4,509	3,121	21.46%	25.51%	22.53%	1.89%	2.32%	1.93%
Southern Arizona Community Bank	1,082	1,189	1,290	12.04%	13.51%	14.74%	1.22%	1.39%	1.46%
Sunrise Bank of Albuquerque	601	494	929	8.95%	7.50%	13.58%	0.86%	0.86%	1.36%
Sunrise Bank of Arizona	409	1,372	2,215	3.51%	10.82%	18.12%	0.35%	1.17%	1.82%
Valley First Community Bank	327	716	604	4.10%	9.67%	9.06%	0.46%	0.97%	0.86%
Yuma Community Bank	936	1,199	992	12.09%	16.95%	14.88%	1.28%	1.70%	1.66%
Arizona Region Total	13,112	15,980	15,305						
California Region:									
Bank of Escondido	505	787	452	3.54%	7.70%	4.78%	0.58%	1.04%	0.72%
Bank of Feather River ⁽¹⁾	(576)								
Bank of San Francisco ⁽³⁾	(397)	(484)	(726)						
Bank of Santa Barbara ⁽³⁾	(191)	(630)	(514)						
Napa Community Bank	1,542	1,572	965	11.73%	13.65%	9.47%	1.29%	1.86%	1.27%
Point Loma Community Bank	168	196	(467)	2.37%	2.84%		0.31%	0.48%	
Sunrise Bank of San Diego	432	885	1,095	4.06%	8.18%	10.18%	0.50%	1.27%	1.69%
Sunrise Community Bank ⁽¹⁾	(998)								
California Region Total	485	2,326	805						
Colorado Region:									
Fort Collins Commerce Bank ⁽³⁾	588	170	(396)	6.81%	2.10%		1.07%	0.42%	
Larimer Bank of Commerce ⁽¹⁾	(586)								
Loveland Bank of Commerce ⁽¹⁾	(426)								
Colorado Region Total	(424)	170	(396)						
Great Lakes Region:									
Ann Arbor Commerce Bank	3,635	3,739	4,007	13.56%	14.19%	14.80%	1.08%	1.21%	1.22%
Bank of Auburn Hills ⁽³⁾	(335)	(332)	(437)						
Bank of Maumee ⁽²⁾	(1,063)	(619)							
Bank of Michigan ⁽³⁾	(136)	(343)	(1,017)						
Brighton Commerce Bank	621	845	1,097	6.63%	8.93%	11.86%	0.58%	0.80%	1.02%
Capitol National Bank	1,977	2,879	3,510	10.45%	14.97%	18.62%	0.84%	1.20%	1.46%
Detroit Commerce Bank	241	942	633	2.57%	11.23%	9.15%	0.22%	0.99%	0.80%
Elkhart Community Bank	766	948	726	8.67%	11.18%	9.21%	0.90%	1.16%	0.97%
Evansville Commerce Bank ⁽²⁾	(689)	(851)							
Goshen Community Bank	431	383	47	5.72%	5.58%	0.71%	0.54%	0.55%	0.08%
Grand Haven Bank	483	1,284	999	4.43%	11.75%	9.75%	0.37%	1.01%	0.82%
Kent Commerce Bank	(161)	365	678		4.72%	8.14%		0.44%	0.79%
Macomb Community Bank	(1,118)	58	442		0.66%	5.03%		0.06%	0.47%
Muskegon Commerce Bank	(1,145)	158	1,184		1.87%	12.52%		0.16%	1.23%
Oakland Commerce Bank	(461)	1,143	1,835		11.50%	17.75%		0.94%	1.46%
Ohio Commerce Bank ⁽²⁾	(770)	(383)							
Paragon Bank & Trust	(187)	858	819		7.71%	7.18%		0.85%	0.74%
Portage Commerce Bank	2,252	2,706	2,940	13.82%	16.72%	18.31%	1.21%	1.51%	1.56%
Great Lakes Region Total	4,341	13,780	17,463						

Net income and the related rates of return on average equity and assets – continued:

	Net Income			Return on Average Equity			Return on Average Assets		
	2007	2006	2005	2007	2006	2005	2007	2006	2005
Midwest Region									
Bank of Belleville ⁽³⁾	\$ (572)	\$ (548)	\$ (405)						
Community Bank of Lincoln ⁽¹⁾	(500)								
Summit Bank of Kansas City ⁽³⁾	(404)	(593)	(319)						
Midwest Region Total	(1,476)	(1,141)	(724)						
Nevada Region:									
1 st Commerce Bank ⁽²⁾	(578)	(432)							
Bank of Las Vegas	608	707	670	6.77%	7.24%	9.70%	0.83%	1.09%	1.16%
Black Mountain Community Bank	2,612	2,556	2,204	18.40%	20.40%	20.95%	1.81%	1.96%	1.84%
Desert Community Bank	1,296	1,302	1,061	13.54%	15.29%	13.65%	1.35%	1.51%	1.42%
Red Rock Community Bank	1,652	2,162	1,856	12.34%	17.38%	15.32%	1.44%	2.09%	1.73%
Nevada Region Total	5,590	6,295	5,791						
Northeast Region:									
USNY Bank ⁽¹⁾	(908)								
Northwest Region:									
Bank of Bellevue ⁽³⁾	(154)	(384)	(551)						
Bank of Everett ⁽²⁾	(636)	(733)							
Bank of Tacoma ⁽¹⁾	(1,067)								
High Desert Bank ⁽¹⁾	(514)								
Issaquah Community Bank ⁽¹⁾	(574)								
Northwest Region Total	(2,945)	(1,117)	(551)						
Southeast Region:									
Bank of Valdosta ⁽²⁾	(423)	(822)							
Community Bank of Rowan ⁽²⁾	(183)	(1,095)							
First Carolina State Bank	539	637	478	4.52%	5.59%	4.42%	0.53%	0.75%	0.64%
Peoples State Bank ⁽³⁾	254	282	77	5.14%	6.57%	2.90%	0.93%	0.55%	0.36%
Sunrise Bank of Atlanta ⁽²⁾	(338)	(820)							
Southeast Region Total	(151)	(1,818)	555						
Texas Region:									
Bank of Fort Bend ⁽¹⁾	(461)								
Bank of Las Colinas ⁽¹⁾	(658)								
Texas Region Total	(1,119)								
Other, net	5,432	7,916	(2,323)						
Consolidated totals	\$ 21,937	\$ 42,391	\$ 35,925	5.72%	12.94%	13.34%	0.49%	1.12%	1.08%

- (1) Became a Capitol affiliate in 2007 and is included for periods after addition to the Capitol banking network.
- (2) Became a Capitol affiliate in 2006 and is included for periods after addition to the Capitol banking network.
- (3) Became a Capitol affiliate in 2005 and is included for periods after addition to the Capitol banking network.

The preceding table presents net income (or loss) of each bank without regard to Capitol's direct or indirect ownership percentage. Young *de novo* banks are expected to incur operating losses in their early periods of operations and, due to Capitol's ownership percentage, individual start-up losses at banks typically do not have a material effect on consolidated earnings.

Earnings at mature wholly-owned banks have a more significant and direct impact on consolidated earnings. The preceding table indicates a significant decrease in combined net income of banks within the Great Lakes Region. Dominating the Great Lakes Region are Capitol's eleven mature, wholly-owned banks located in Michigan. Total earnings of this group of banks amounted to \$6.1 million in 2007, compared to \$15 million in 2006 and \$18.1 million in 2005. The material decrease in earnings in this group of banks is attributable

to loan losses stemming from a sustained difficult economic environment, significant increases in nonearning assets and elevated collection costs. These are the largest items adversely impacting Capitol's 2007 consolidated earnings results, followed by compression in margins and related net interest income.

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 \$183.3 million in 2007, a 5% increase over the \$173.8 million reported in 2006, compared to an 11% increase in 2006 versus 19% in 2005. The 2007 increase in net interest income is substantially less than the growth rate in loans, other earning assets and deposits due to a challenging interest rate environment which reduced the spread between interest earned on loans and rates paid on deposits. In 2006 and 2005, double-digit asset growth generally correlated with somewhat similar double-digit growth in net interest income, although margin compression reduced the growth rate of net interest income in the second half of 2006. The modest 2007 increase in net interest income is due to the compression in margins caused by lower rates earned on loans and elevated levels of nonperforming loans coupled with the slower repricing of rates paid on deposits.

Combined with noninterest income, total consolidated net operating revenues approximated \$207.7 million in 2007, \$195.3 million in 2006 and \$177.9 million in 2005. Noninterest income for these periods was \$24.4 million, \$21.5 million and \$21 million, respectively. Noninterest income increased 13% in 2007.

Service charges, which approximated \$4.8 million in 2007, increased 9% from the 2006 level of \$4.3 million (\$4.1 million in 2005). Revenue from trust and wealth management activities increased more than 54% in 2007 and 61% in 2006, following the late-2005 launch of Capitol Wealth, Inc., 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 are located at a majority of Capitol's banks to work in tandem with their traditional banking colleagues to expand the availability of financial services to the banks' clientele, while increasing noninterest revenues.

In 2007, 2006 and 2005, revenue from mortgage loans originated for sale amounted to \$4.5 million, \$5.4 million and \$6.1 million, respectively. Loan origination volume decreased in 2006 and 2005 and increased slightly in 2007. Increased interest rates on mortgage loans in 2006 and 2007 substantially reduced origination volume from refinancings. Further, reduction in home sales volume in many communities has also negatively impacted origination volume. Other noninterest income increased 20% in 2007 and 5% in 2006. 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.

The provision for loan losses approximated \$25.3 million, \$12.2 million and \$11 million in 2007, 2006 and 2005, respectively. The very significant increase in the provision for loan losses in 2007 is primarily associated with loan losses incurred in the Great Lakes Region's mature wholly-owned Michigan banks and related elevated levels of nonperforming loans. 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 \$176.2 million, \$137.8 million and \$117.3 million in 2007, 2006 and 2005, respectively. In total, these expenses increased 27.8% in 2007, 17.5% in 2006 and 19.9% in 2005. Increases in the components of noninterest expense in 2007 were primarily associated with added staffing and other costs associated with growing young banks and adding new banks (eleven in 2007 and nine in each of 2006 and 2005). The more significant elements of other noninterest expense consisted of the following (in \$1,000s):

	2007	2006	2005
Advertising	\$ 3,315	\$ 2,921	\$ 2,266
Travel, lodging and meals	3,080	2,322	1,623
Paper, printing and supplies	2,870	2,409	2,135
Directors' fees	2,819	2,196	1,577
FDIC insurance premiums and other			
regulatory fees	2,723	879	837
Professional fees	2,468	2,547	2,124
Bank services (ATMs, telephone			
banking and Internet banking)	2,115	1,564	1,229
Loan and collection expense	1,952	1,116	1,059
Taxes other than income taxes	1,786	1,372	1,401
Communications	1,728	1,380	1,229
Postage	1,113	1,009	864
Courier service	997	872	803
Costs associated with foreclosed			
properties and other real estate owned	989	417	8
Dues and memberships	928	810	592
Contracted labor	496	549	370
Insurance expense	473	398	386
Other	8,951	4,880	7,324
Total	<u>\$ 38,803</u>	<u>\$ 27,641</u>	<u>\$ 25,827</u>

Capitol's effective tax rate was 45.9% in 2007, 34.1% in 2006 and 38.7% in 2005. 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 higher effective tax rate in 2007 resulted primarily from lower taxable income while nondeductible items were relatively consistent with prior years.

Capitol's Financial Position

Consolidated total assets increased significantly in 2007 to \$4.9 billion from \$4.1 billion at the end of 2006 and \$3.5 billion at the beginning of 2006.

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 \$701.5 million or 14.3% of total assets) and liquidity (cash and cash equivalents of \$352.4 million or 7.2% of total assets) at December 31, 2007. Both of those key elements are discussed in the next section, *Liquidity, Capital Resources and Capital Adequacy*.

When considering 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 \$4.3 billion at December 31, 2007 and \$3.4 billion at December 31, 2006. These amounts approximated 87% of total consolidated assets at December 31, 2007 and 85% at December 31, 2006. Loan growth in 2007 approximated \$826 million (\$497.5 million in 2006). On a consolidated basis, portfolio loan growth at banks less than three years of age as of year-end 2007 approximated 66% 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 may be 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, 2007, the consolidated allowance for loan losses approximated \$58.1 million or 1.35% of total portfolio loans outstanding, compared with \$45.4 million or 1.30% at December 31, 2006. 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 \$72.6 million and \$34.3 million at December 31, 2007 and 2006, and approximated 1.68% and 0.98% of portfolio loans and 1.48% and 0.84% of total assets, respectively. Of the nonperforming loans at December 31, 2007, about 86% were real-estate secured. At December 31, 2007, the coverage ratio of the allowance for loan losses to nonperforming loans (i.e., the allowance as a percentage of nonperforming loans) was 80%, compared to 132.5% at the beginning of the year.

At December 31, 2007, about 71% of Capitol's total nonperforming loans were Michigan-based (including nonperforming loans held at the parent level) where nonperforming loans increased \$20 million or 63% in 2007. In concert with elevated levels of nonperforming loans at Michigan banks, their combined allowance ratio of about 1.58% and 1.48% of portfolio loans at year-end 2007 and 2006, respectively, has been maintained at a higher level than the consolidated ratio, and some banks have allowance ratios exceeding 2%. Although the majority of nonperforming loans at December 31, 2007 were Michigan-based, it should be noted that other regions (Arizona and California, for example) experienced increases in this category in 2007. Increases in other regions' nonperforming loans were expected due to softened economic conditions and the historically low levels of such loans in prior periods.

Due to a combination of commercial real estate collateral and a weak economic climate, 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, 2007.

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 grades 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, 2007, potential problem loans (which include nonperforming loans) approximated \$219 million or about 5% 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 there is no one 'right' way. Management's experience is that its estimation techniques have accurately determined historical losses.

Capitol had 60 separately chartered banks at year-end 2007. 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 by 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.

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	
	2007	2006	2007	2006	2007	2006	2007	2006
Arizona Region:								
Arrowhead Community Bank	\$ 81,836	\$ 71,252	\$ 818	\$ 720	\$ 361	\$ 855	1.00%	1.01%
Asian Bank of Arizona ⁽²⁾	21,514	14,499	405	200	314		1.88%	1.38%
Bank of Tucson	168,427	160,009	1,385	1,472	752	199	0.82%	0.92%
Camelback Community Bank	79,869	78,922	800	733	451	46	1.00%	0.93%
Mesa Bank	202,511	189,863	1,760	1,794	3,699		0.87%	0.94%
Southern Arizona Community Bank	78,467	77,845	792	775	600	16	1.01%	1.00%
Sunrise Bank of Albuquerque	67,192	53,027	866	778	183		1.29%	1.47%
Sunrise Bank of Arizona	112,211	112,720	1,125	1,126	4,250	246	1.00%	1.00%
Valley First Community Bank	71,689	66,256	653	611			0.91%	0.92%
Yuma Community Bank	66,092	58,577	525	500	600		0.79%	0.85%
Arizona Region Total	949,808	882,970	9,129	8,709	11,210	1,362	0.96%	0.99%
California Region:								
Bank of Escondido	54,707	37,398	560	370	311	19	1.02%	0.99%
Bank of Feather River ⁽¹⁾	13,345		187				1.40%	
Bank of San Francisco	44,989	26,415	695	375	392		1.54%	1.42%
Bank of Santa Barbara	52,340	40,198	741	533			1.42%	1.33%
Napa Community Bank	100,253	78,467	1,069	1,020	1,459		1.07%	1.30%
Point Loma Community Bank	49,607	38,018	695	510			1.40%	1.34%
Sunrise Bank of San Diego	74,526	65,250	908	540	2,386		1.22%	0.83%
Sunrise Community Bank ⁽¹⁾	17,624		255				1.45%	
California Region Total	407,391	285,746	5,110	3,348	4,548	19	1.25%	1.17%
Colorado Region:								
Fort Collins Commerce Bank	59,388	52,147	889	695			1.50%	1.33%
Larimer Bank of Commerce ⁽¹⁾	50,927		765				1.50%	
Loveland Bank of Commerce ⁽¹⁾	15,253		229				1.50%	
Colorado Region Total	125,568	52,147	1,883	695			1.50%	1.33%
Great Lakes Region:								
Ann Arbor Commerce Bank	332,624	288,408	4,504	4,393	5,161	4,441	1.35%	1.52%
Bank of Auburn Hills	36,586	26,432	820	410	1,293	629	2.24%	1.55%
Bank of Maumee ⁽²⁾	32,102	3,327	482	50			1.50%	1.50%
Bank of Michigan	63,448	44,630	952	669	370		1.50%	1.50%
Brighton Commerce Bank	99,627	94,987	1,018	995	18	522	1.02%	1.05%
Capitol National Bank	206,449	196,074	3,421	2,833	3,449	3,365	1.66%	1.44%
Detroit Commerce Bank	108,992	103,153	1,355	1,335	3,948	1,328	1.24%	1.29%
Elkhart Community Bank	83,754	77,515	1,282	1,010	2,677	676	1.53%	1.30%
Evansville Commerce Bank ⁽¹⁾	48,113	14,711	720	232	80		1.50%	1.58%
Goshen Community Bank	70,799	63,653	874	862	491	233	1.23%	1.35%
Grand Haven Bank	122,208	120,025	2,644	2,643	6,970	2,682	2.16%	2.20%
Kent Commerce Bank	83,357	83,065	1,527	1,237	2,456	2,256	1.83%	1.49%
Macomb Community Bank	87,670	87,737	2,283	1,670	11,846	3,738	2.60%	1.90%
Muskegon Commerce Bank	90,031	81,799	1,762	1,231	2,362	3,906	1.96%	1.50%
Oakland Commerce Bank	99,770	114,876	1,816	1,636	3,803	2,862	1.82%	1.42%
Ohio Commerce Bank ⁽²⁾	29,110	739	437	11			1.50%	1.49%
Paragon Bank & Trust	91,481	82,259	1,431	1,298	2,220	2,132	1.56%	1.58%
Portage Commerce Bank	179,219	167,005	1,812	1,729	1,127	1,380	1.01%	1.04%
Great Lakes Region Total	1,865,340	1,650,395	29,140	24,244	48,271	30,150	1.56%	1.47%
Midwest Region:								
Bank of Belleville	46,951	17,410	700	260			1.49%	1.49%
Community Bank of Lincoln ⁽¹⁾	10,501		168				1.60%	
Summit Bank of Kansas City	45,165	15,645	641	235			1.42%	1.50%
Midwest Region Total	102,617	33,055	1,509	495			1.47%	1.50%

Summary of loan information – continued:

	Total Portfolio Loans		Allowance for Loan Losses		Nonperforming Loans		Allowance as a % of Total Portfolio Loans	
	2007	2006	2007	2006	2007	2006	2007	2006
Nevada Region:								
1 st Commerce Bank ⁽²⁾	\$ 27,030	\$ 9,588	\$ 393	\$ 125			1.45%	1.30%
Bank of Las Vegas	61,662	62,818	751	705			1.22%	1.12%
Black Mountain Community Bank	137,308	127,844	1,415	1,529	\$ 659		1.03%	1.20%
Desert Community Bank	90,050	83,284	837	830	356	\$ 137	0.93%	1.00%
Red Rock Community Bank	106,559	100,010	977	1,084	64	151	0.92%	1.08%
Nevada Region Total	422,609	383,544	4,373	4,273	1,079	288	1.03%	1.11%
Northeast Region:								
USNY Bank ⁽¹⁾	12,421		187				1.51%	
Northwest Region:								
Bank of Bellevue	37,364	28,037	665	370	222		1.78%	1.32%
Bank of Everett ⁽²⁾	24,170	8,269	418	122			1.73%	1.48%
Bank of Tacoma ⁽¹⁾	19,639		285				1.45%	
High Desert Bank ⁽¹⁾	9,080		126				1.39%	
Issaquah Community Bank ⁽¹⁾	6,598		93				1.41%	
Northwest Region Total	96,851	36,306	1,587	492	222		1.64%	1.36%
Southeast Region:								
Bank of Valdosta ⁽²⁾	41,629	18,870	619	283			1.49%	1.50%
Community Bank of Rowan ⁽²⁾	96,271	36,534	1,444	534			1.50%	1.46%
First Carolina State Bank	94,047	73,884	1,157	800	829	150	1.23%	1.08%
Peoples State Bank	13,609	15,154	247	263	86		1.81%	1.74%
Sunrise Bank of Atlanta ⁽²⁾	45,024	14,553	760	215			1.69%	1.48%
Southeast Region Total	290,580	158,995	4,227	2,095	915	150	1.45%	1.32%
Texas Region:								
Bank of Fort Bend ⁽¹⁾	3,140		46				1.47%	
Bank of Las Colinas ⁽¹⁾	9,830		144				1.46%	
Texas Region Total	12,970		190				1.46%	
Other, net	28,546	5,520	789	1,063	6,385	2,305	2.76%	19.26%
Consolidated totals	\$ 4,314,701	\$ 3,488,678	\$ 58,124	\$ 45,414	\$ 72,630	\$ 34,274	1.35%	1.30%

(1) Became a Capitol affiliate in 2007 and is included for periods after addition to the Capitol banking network.

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

There are several other asset categories. Loans held for sale (\$16.4 million and \$34.6 million at December 31, 2007 and 2006, respectively) are home mortgages which are sold into the secondary market generally within 30-60 days of closing (discussed in more detail in the following section of this narrative). There is also a modest amount of investment securities on the balance sheet (\$39.6 million and \$40.7 million at December 31, 2007 and 2006, respectively). Goodwill and other intangibles increased to \$72.7 million at year-end 2007, an increase of \$10.5 million primarily resulting from a share-exchange transaction; accounting for goodwill is described in the *Critical Accounting Policies* section of this narrative. All other asset categories are individually less than \$85 million at December 31, 2007 and 2006.

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 \$382.9 million at year-end 2007, or about 7.8% of total assets. This compares to \$402.4 million or about 9.9% of total assets at year-end 2006. 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 a third of the investment securities portfolio is classified as available for sale, although the banks generally have not sold investments to meet liquidity needs. During 2007 and 2006, there were no significant sales of investment securities available for sale (\$1.8 million in 2005). Sales of investment securities available for sale are typically made to facilitate changes in risk-management strategies.

Loans held for sale, as previously mentioned, approximated \$16.4 million at December 31, 2007, compared to \$34.6 million at year-end 2006. 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. In 2007, reports of turmoil relating to subprime mortgage activity dominated the media; Capitol's banks' mortgage lending activity is an extension of its relationship-based operating model. Mortgage loan origination volume in 2007 increased slightly, to approximately \$500 million compared to \$483.9 million in 2006 and \$634.4 million in 2005. The increase in volume was primarily due to lower interest rates in the second half of 2007 versus the higher rates in 2005 and 2006 after record low interest rates, which generated 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 17% of total deposits at year-end 2007 (about 20% at year-end 2006). The decrease in this ratio is significant inasmuch as a lower percentage of noninterest-bearing deposits has the effect of increasing a bank's funding costs and, accordingly, reducing net interest income.

In recent periods, many banks within the industry have experienced 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 requires competitive pricing, resulting in tight net interest margins, especially during periods of relatively low interest rates. As interest rates have recently decreased, customers are more attracted to aggressively-priced time deposits, and

growth in noninterest-bearing balances is very difficult to achieve. The banks do not generally rely on brokered deposits as a key funding source (approximately \$533 million at year-end 2007 or 13.9% of interest-bearing deposits compared to 13.6% in 2006); 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 2007, a total of approximately \$299 million (\$184 million at year-end 2006) was borrowed under those facilities and additional borrowing availability approximated \$490 million. Some of the banks also have smaller lines of credit with their correspondent banks. Borrowings under those 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 2007 and 2006, 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	\$2,023,628	\$2,023,628			
Time deposits	1,821,117	1,524,347	\$ 241,596	\$ 53,604	\$ 1,570
Debt obligations	320,384	176,234	128,700	15,344	106
Rent commitments under noncancelable leases	56,238	9,098	15,935	13,447	17,758
Trust-preferred securities	<u>158,300</u>				<u>158,300</u>
Total	<u>\$4,379,667</u>	<u>\$3,733,307</u>	<u>\$ 386,231</u>	<u>\$ 82,395</u>	<u>\$ 177,734</u>

(1) Excludes interest.

Loan commitments of Capitol's banks (stand-by letters of credit and unfunded loans) generally expire within one year. Other than the items set forth above, there are no individually material contractual obligations, such as purchase obligations.

A significant source of capital has been investments 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 \$156.2 million at year-end 2007, a net increase of \$29.7 million from the \$126.5 million level at year-end 2006. The net increase in minority interests in 2007 resulted 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 bank-development entity) is owned by Capitol. All of the nonvoting common stock, ranging from \$12.7 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-VII. CDBL-I became wholly-owned via a share-exchange with Capitol effective November 30, 2006. CDBL-II became wholly-owned via a share exchange with Capitol completed in February 2007 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, in the future, it is likely that share exchange transactions may occur, as a strategy to gain full ownership of some majority-owned affiliates, 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. For example, in April 2005, Capitol acquired Peoples State Bank located in Jeffersonville, Georgia, which subsequently enabled Capitol to form and/or acquire banks in that state.

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 \$389.1 million at year-end 2007, an increase of \$27.3 million for the year. The 2007 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 \$22.47 at year-end 2007, compared with \$21.73 at year-end 2006. Cash dividends per share of \$1.00 were paid in 2007, compared to \$0.95 in 2006 and \$0.72 in 2005. In early 2008, 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 \$158 million of capital through issuance of trust-preferred securities, including \$55 million in March 2007. 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. Future availability of trust-preferred securities as a near-term capital resource diminished in late 2007 as U.S. capital markets became unstable, which precludes this as a capital resource until capital market conditions improve.

Total capitalization at year-end 2007 amounted to \$701.5 million, or 14.3% of total assets. This compares to \$589.4 million, or 14.5% at year-end 2006.

At December 31, 2007, Capitol and its bank-development subsidiaries had \$27.7 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 have previously benefitted from lower FDIC deposit insurance costs and less restrictive limitations on some banking activities which are attributable to that classification. Increases in FDIC insurance premiums experienced by Capitol's banks in 2007 were attributable to general increases in FDIC assessments, not due to their capital classification.

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 2007.

Trends Affecting Operations

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

Changes in interest rates, either up or down, have an impact on net interest income (plus or minus), depending 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 the "gap" at December 31, 2007 (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	\$ 22,541	\$ 3,091	\$ 198	\$ 1,094	\$ 26,924
Federal funds sold	129,365				129,365
Loans held for sale	16,419				16,419
Investment securities	20,271	777	6,645	11,904	39,597
Portfolio loans	1,698,824	488,514	1,878,942	248,421	4,314,701
Nonearning assets					<u>374,757</u>
Total assets	<u>\$ 1,887,420</u>	<u>\$ 492,382</u>	<u>\$ 1,885,785</u>	<u>\$ 261,419</u>	<u>\$ 4,901,763</u>
LIABILITIES AND STOCKHOLDERS' EQUITY					
Interest-bearing deposits:					
Time deposits under \$100,000	\$ 275,273	\$ 363,048	\$ 114,697	\$ 894	\$ 753,912
Time deposits \$100,000 and over	407,957	478,069	180,503	676	1,067,205
All other interest-bearing deposits	<u>926,304</u>	<u>177,348</u>	<u>240,157</u>	<u>8,131</u>	<u>1,351,940</u>
Total interest-bearing deposits	1,609,534	1,018,465	535,357	9,701	3,173,057
Notes payable and short-term borrowings	90,535	85,699	144,044	106	320,384
Trust preferred securities	68,000		35,000	55,300	158,300
Noninterest-bearing liabilities					704,679
Minority interests in consolidated subsidiaries					156,198
Stockholders' equity					<u>389,145</u>
Total liabilities and stockholders' equity	<u>\$ 1,768,069</u>	<u>\$ 1,104,164</u>	<u>\$ 714,401</u>	<u>\$ 65,107</u>	<u>\$ 4,901,763</u>
Interest rate sensitive period gap	<u>\$ 119,351</u>	<u>\$ (611,782)</u>	<u>\$ 1,171,384</u>	<u>\$ 196,312</u>	
Interest rate sensitive cumulative gap	<u>\$ 119,351</u>	<u>\$ (492,431)</u>	<u>\$ 678,953</u>	<u>\$ 875,265</u>	
Period rate sensitive assets/period rate sensitive liabilities	1.07	0.45	2.64	4.02	
Cumulative rate sensitive assets/cumulative rate sensitive liabilities	1.07	0.83	1.19	1.24	
Cumulative gap to total assets	2.43%	(10.05)%	13.85%	17.86%	

The table on the preceding page indicates that, in the immediate short-term, Capitol is slightly “asset sensitive” (i.e., interest-rate sensitive assets exceed interest-rate sensitive liabilities) and, accordingly, if interest rates increase it would favorably impact net interest income. Early 2008 reality, however, was a falling rate environment with unprecedented large rate cuts made by the Federal Reserve in January. 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 100 and 200 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	\$ 358,877	\$ 383,200	\$ 407,570	\$ 334,553	\$ 310,505
Interest expense	<u>189,394</u>	<u>213,826</u>	<u>238,258</u>	<u>164,295</u>	<u>139,195</u>
Net interest income	<u>\$ 169,483</u>	<u>\$ 169,374</u>	<u>\$ 169,312</u>	<u>\$ 170,258</u>	<u>\$ 171,310</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 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.

As mentioned previously, the Federal Reserve took unprecedented action in January 2008 to reduce market interest rates by a total of 125 basis points. Because of Capitol's consolidated asset-sensitive gap position such action is expected to have an adverse impact on net interest margin (and profitability) as interest rates on loans reprice quickly while rates paid on deposits will reprice over an extended period of time. At the time this narrative was written, there appeared to be consensus within the financial media that the Federal Reserve may reduce interest rates by another 100 basis points by mid-2008. If that occurs, Capitol's net interest margins could become further compressed. It is impossible to speculate further on the timing, size and direction of future interest rate changes.

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 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 a continuing adverse impact on the communities in which the banks are located. At the time this narrative was written, stresses of the domestic economic and global instability 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.

Capitol continues to expand geographically to minimize or avoid a concentration of assets in a particular region. The Great Lakes Region comprised 41.7% of consolidated assets at December 31, 2007, compared to 46.7% at December 31, 2006, and is disproportionate to other denominated regions of Capitol. Future asset growth and bank development is expected to emphasize other regions, improving the balance of Capitol's geographic presence and to reduce the exposure to adverse economic conditions of any particular region.

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 been maintained at a stable and modest level for the last several years, until mid-2007 (\$362,000 in 2006 and \$375,000 in 2005). FDIC deposit insurance premium levels became a much more significant expense in 2007 (\$2.0 million) and will increase in future periods as a result of the FDIC imposing 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 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 financial institution 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, 2007, Capitol's allowance for loan losses approximated 1.35% 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 \$430,000 impact on both the allowance for loan losses and income before income taxes.

Accounting for Goodwill and Other Intangibles. At December 31, 2007, Capitol had \$72.7 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 result of share-exchange transactions when Capitol has issued its shares of common stock at a 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, 2007.

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. However, after giving effect to the minority interest in net income or losses of consolidated subsidiaries, Capitol's net income 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 2007, in addition to some which have later effective dates. Those are listed and discussed in Note B of the consolidated financial statements, beginning on page F-46.

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 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 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.


Management's Report on 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, 2007, 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, 2007, 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 Capitol's internal control over financial reporting.



Joseph D. Reid
Chairman and CEO



Lee W. Hendrickson
Chief Financial Officer

Lansing, Michigan
March 10, 2008



Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Capitol Bancorp Ltd.

We have audited Capitol Bancorp Ltd. and subsidiaries' internal control over financial reporting as of December 31, 2007, 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, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included 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, Capitol Bancorp Ltd. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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 of Capitol Bancorp Ltd. and subsidiaries as of December 31, 2007 and 2006, 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, 2007, and our report dated March 10, 2008 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Grand Rapids, Michigan
March 10, 2008



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, 2007 and 2006, 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, 2007. 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, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, 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), Capitol Bancorp Ltd. and subsidiaries' internal control over financial reporting as of December 31, 2007, 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 10, 2008 expressed an unqualified opinion thereon.

Grand Rapids, Michigan
March 10, 2008

Consolidated Balance Sheets

	-December 31-	
	2007	2006
	(in \$1,000s)	
ASSETS		
Cash and due from banks	\$ 196,083	\$ 169,753
Money market and interest-bearing deposits	26,924	37,204
Federal funds sold	<u>129,365</u>	<u>141,913</u>
Cash and cash equivalents	352,372	348,870
Loans held for sale	16,419	34,593
Investment securities—Note C:		
Available for sale, carried at market value	14,119	18,904
Held for long-term investment, carried at amortized cost which approximates market value	<u>25,478</u>	<u>21,749</u>
Total investment securities	39,597	40,653
Portfolio loans, less allowance for loan losses of \$58,124 in 2007 and \$45,414 in 2006—Note D	4,256,577	3,443,264
Premises and equipment—Note F	60,031	54,295
Accrued interest income	19,417	17,524
Goodwill and other intangibles—Notes B and R	72,722	62,215
Other assets	<u>84,628</u>	<u>64,402</u>
TOTAL ASSETS	<u>\$ 4,901,763</u>	<u>\$ 4,065,816</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest bearing	\$ 671,688	\$ 651,253
Interest-bearing—Note G	<u>3,173,057</u>	<u>2,607,232</u>
Total deposits	3,844,745	3,258,485
Debt obligations:		
Notes payable and short-term borrowings—Note H	320,384	191,154
Subordinated debentures—Note I	<u>156,130</u>	<u>101,035</u>
Total debt obligations	476,514	292,189
Accrued interest on deposits and other liabilities	<u>35,161</u>	<u>26,751</u>
Total liabilities	4,356,420	3,577,425
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES—Note A	156,198	126,512
STOCKHOLDERS' EQUITY—Notes B, J and P		
Common stock, no par value, 50,000,000 shares authorized; issued and outstanding: 2007 – 17,316,568 shares 2006 – 16,656,481 shares	272,208	249,244
Retained earnings	117,520	112,779
Undistributed common stock held by employee-benefit trust	(586)	
Market value adjustment (net of tax effect) for investment securities available for sale (accumulated other comprehensive income/loss)	<u>3</u>	<u>(144)</u>
Total stockholders' equity	<u>389,145</u>	<u>361,879</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 4,901,763</u>	<u>\$ 4,065,816</u>

See notes to consolidated financial statements.

Consolidated Statements of Income

	-Year Ended December 31-		
	2007	2006	2005
	(in \$1,000s except per share data)		
Interest income:			
Portfolio loans (including fees)	\$ 314,800	\$ 264,701	\$ 214,882
Loans held for sale	2,133	2,740	2,627
Taxable investment securities	773	956	1,008
Federal funds sold	10,687	8,703	4,734
Other	<u>2,046</u>	<u>2,253</u>	<u>1,188</u>
Total interest income	330,439	279,353	224,439
Interest expense:			
Deposits	124,160	88,629	53,213
Debt obligations and other	<u>23,002</u>	<u>16,957</u>	<u>14,366</u>
Total interest expense	<u>147,162</u>	<u>105,586</u>	<u>67,579</u>
Net interest income	183,277	173,767	156,860
Provision for loan losses—Note D	<u>25,340</u>	<u>12,156</u>	<u>10,960</u>
Net interest income after provision for loan losses	157,937	161,611	145,900
Noninterest income:			
Service charges on deposit accounts	4,787	4,318	4,120
Trust and wealth-management revenue	5,149	3,336	2,069
Fees from origination of non-portfolio residential mortgage loans	4,482	5,439	6,146
Gains on sale of government-guaranteed loans	2,733	2,434	2,980
Realized gains (losses) on sales of investment securities available for sale	(2)		8
Other	<u>7,232</u>	<u>6,005</u>	<u>5,725</u>
Total noninterest income	24,381	21,532	21,048
Noninterest expense:			
Salaries and employee benefits	106,563	85,196	72,387
Occupancy	15,079	12,116	9,735
Equipment rent, depreciation and maintenance	10,022	8,389	6,369
Preopening and start-up costs of <i>de novo</i> banks and bank-development subsidiaries	5,693	4,462	2,971
Other	<u>38,803</u>	<u>27,641</u>	<u>25,827</u>
Total noninterest expense	<u>176,160</u>	<u>137,804</u>	<u>117,289</u>
Income before income taxes and minority interest	6,158	45,339	49,659
Income taxes—Note L	<u>2,824</u>	<u>15,463</u>	<u>19,232</u>
Income before minority interest	3,334	29,876	30,427
Minority interest in net losses of consolidated subsidiaries	<u>18,603</u>	<u>12,515</u>	<u>5,498</u>
 NET INCOME	 <u>\$ 21,937</u>	 <u>\$ 42,391</u>	 <u>\$ 35,925</u>
 NET INCOME PER SHARE—Note M:			
Basic	<u>\$ 1.29</u>	<u>\$ 2.69</u>	<u>\$ 2.42</u>
Diluted	<u>\$ 1.27</u>	<u>\$ 2.57</u>	<u>\$ 2.34</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	Undistributed Common Stock Held by Employee- Benefit Trust	Accumulated Other Comprehensive Income (Loss)	Total
Balances at January 1, 2005	\$ 191,719	\$ 60,476		\$ (36)	\$ 252,159
Issuance of 610,383 shares of common stock to acquire minority interest 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				(190)	(190)
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				82	82
BALANCES AT DECEMBER 31, 2006	249,244	112,779		(144)	361,879
Issuance of 371,314 shares of common stock to acquire minority interest in subsidiary	15,927				15,927
Issuance of 222,295 shares of common stock upon exercise of stock options, net of common stock surrendered to facilitate exercise	2,836				2,836
Recognition of compensation expense relating to restricted common stock (\$1,562) and stock options	1,972				1,972
Issuance of 41,972 unvested shares of restricted common stock, net of related unearned employee compensation and 2,000 forfeited shares	--				--
Tax benefit from share-based payments	1,688				1,688
Issuance of 24,506 shares to ESOP	1,132				1,132
Acquisition of 85,543 shares for employee benefit trust			\$ (2,482)		(2,482)
Transfer of 64,430 shares to ESOP and distribution of 435 shares to employees upon anniversary of employment	(591)		1,896		1,305
Cash dividends paid (\$1.00 per share)		(17,196)			(17,196)
Components of comprehensive income:					
Net income for 2007		21,937			21,937
Market value adjustment for investment securities available for sale (net of income tax effect)				147	147
Comprehensive income for 2007				147	147
BALANCES AT DECEMBER 31, 2007	\$ 272,208	\$ 117,520	\$ (586)	\$ 3	\$ 389,145

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

	-Year Ended December 31-		
	2007	2006	2005
	(in \$1,000s)		
OPERATING ACTIVITIES			
Net income	\$ 21,937	\$ 42,391	\$ 35,925
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	25,340	12,156	10,960
Depreciation of premises and equipment	8,980	7,219	5,661
Amortization of intangibles	315	585	577
Net amortization (accretion) of investment security premiums (discounts)	11	(8)	63
Loss (gain) on sales of premises and equipment	(57)	18	157
Minority interest in net losses of consolidated subsidiaries	(18,603)	(12,515)	(5,498)
Share-based compensation expense	1,972	1,689	1,242
Deferred federal income tax credit	(10,397)	(5,493)	(5,263)
Originations and purchases of loans held for sale	(499,787)	(483,850)	(634,362)
Proceeds from sales of loans held for sale	517,961	470,895	655,867
Increase in accrued interest income and other assets	(11,292)	(17,504)	(15,815)
Increase (decrease) in accrued interest expense on deposits and other liabilities	8,410	(1,338)	11,801
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>44,790</u>	<u>14,245</u>	<u>61,315</u>
INVESTING ACTIVITIES			
Cash and cash equivalents of acquired subsidiary			3,557
Proceeds from sales of investment securities available for sale	301		1,756
Proceeds from calls, prepayments and maturities of investment securities	11,303	14,266	11,249
Purchases of investment securities	(10,629)	(9,347)	(14,667)
Net increase in portfolio loans	(838,653)	(504,790)	(306,258)
Proceeds from sales of premises and equipment	407	708	93
Purchases of premises and equipment	(15,066)	(20,611)	(14,879)
NET CASH USED BY INVESTING ACTIVITIES	<u>(852,337)</u>	<u>(519,774)</u>	<u>(319,149)</u>
FINANCING ACTIVITIES			
Net increase in demand deposits, NOW accounts and savings accounts	185,376	134,250	85,385
Net increase in certificates of deposit	400,884	338,976	189,802
Net borrowings from debt obligations	129,230	15,425	3,195
Net proceeds from issuance of subordinated debentures	55,000		
Resources provided by minority interests	55,713	68,751	62,794
Net proceeds from issuance of common stock	2,836	3,573	2,510
Tax benefit from share-based payments	1,688	2,481	
Acquisition of shares for employee benefit trust	(2,482)		
Cash dividends paid	(17,196)	(15,165)	(10,848)
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>811,049</u>	<u>548,291</u>	<u>332,838</u>
INCREASE IN CASH AND CASH EQUIVALENTS	<u>3,502</u>	<u>42,762</u>	<u>75,004</u>
Cash and cash equivalents at beginning of year	<u>348,870</u>	<u>306,108</u>	<u>231,104</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 352,372</u>	<u>\$ 348,870</u>	<u>\$ 306,108</u>

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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

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

Affiliate	Location	Percentage Owned at December 31, 2007	Year Formed or Acquired
Arizona Region:			
Arrowhead Community Bank	Glendale, Arizona	100%	2000
Asian Bank of Arizona	Phoenix, Arizona	(1)	2006
Bank of Tucson	Tucson, Arizona	100%	1996
Camelback Community Bank	Phoenix, Arizona	100%	1998
Mesa Bank	Mesa, Arizona	100%	1998
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 Feather River	Yuba City, California	(1)	2007
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
Sunrise Community Bank	Palm Desert, California	(1)	2007
Colorado Region:			
Fort Collins Commerce Bank	Fort Collins, Colorado	51%	2005
Larimer Bank of Commerce	Fort Collins, Colorado	51%	2007
Loveland Bank of Commerce	Loveland, Colorado	51%	2007
Great Lakes Region:			
Ann Arbor Commerce Bank	Ann Arbor, Michigan	100%	1990
Bank of Auburn Hills	Auburn Hills, Michigan	51%	2005
Bank of Maumee	Maumee, Ohio	(1)	2006
Bank of Michigan	Farmington Hills, Michigan	51%	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

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

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, 2007	Year Formed or Acquired
Midwest Region:			
Bank of Belleville	Belleville, Illinois	51%	2005
Community Bank of Lincoln	Lincoln, Nebraska	(1)	2007
Summit Bank of Kansas City	Lee's Summit, Missouri	(1)	2005
Nevada Region:			
1 st Commerce Bank	North Las Vegas, Nevada	(1)	2006
Bank of Las Vegas	Las Vegas, Nevada	100%	2002
Black Mountain Community Bank	Henderson, Nevada	100%	2000
Desert Community Bank	Las Vegas, Nevada	100%	1999
Red Rock Community Bank	Las Vegas, Nevada	100%	1999
Northeast Region:			
USNY Bank	Geneva, New York	(1)	2007
Northwest Region:			
Bank of Bellevue	Bellevue, Washington	51%	2005
Bank of Everett	Everett, Washington	(1)	2006
Bank of Tacoma	Tacoma, Washington	(1)	2007
High Desert Bank	Bend, Oregon	(1)	2007
Issaquah Community Bank	Issaquah, Washington	(1)	2007
Southeast Region:			
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
Texas Region:			
Bank of Fort Bend	Sugar Land, Texas	(1)	2007
Bank of Las Colinas	Irving, Texas	(1)	2007

(1) Majority-owned by a bank development subsidiary in which Capitol holds 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 investment of \$1 million for each bank-development entity) is owned by Capitol. All of the nonvoting common stock, ranging from \$12.7 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-VII. CDBL-I and CDBL-II became wholly-owned by Capitol effective November 30, 2006 and February 9, 2007, respectively (see Note R), and were merged with and into Capitol effective December 31, 2007.

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 (historically, often 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 primarily 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. The majority of Capitol's banks are state-chartered institutions and, commencing in 2007, some have been chartered as federal savings banks. In addition to 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 financial institution 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 2005, 2006 and 2007 are included in the consolidated financial statements for periods after joining the consolidated group. Certain 2006 and 2005 amounts have been reclassified to conform to the 2007 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.

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).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

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 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

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 \$13.9 million and \$8.1 million of net deferred costs as of December 31, 2007 and 2006, respectively).

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, 2007) are charged against earnings, when determined. Other intangibles, which generally consist of acquired customer lists and core deposit intangibles, are amortized over varying periods of 7 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, 2007 and 2006, approximated \$16.4 million and \$9.5 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 estimated 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

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 stock options after January 1, 2006 is recognized ratably over the vesting period of the award based on the fair value of the option, computed using the Black-Scholes valuation model. 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.

Stock price volatility used in the valuation model is 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.

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 were as follows for the year ended December 31, 2005:

Fair value assumptions:	
Risk-free interest rate	4.2%
Dividend yield	2.0%
Stock price volatility	.30
Expected option life	6.8 years
Aggregate estimated fair value of options granted (in thousands)	\$ 9,373
Net income (in thousands):	
As reported	35,925
Pro forma	29,833
Net income per share:	
Basic:	
As reported	2.42
Pro forma	2.01
Diluted:	
As reported	2.34
Pro forma	\$ 1.94

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

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.

Net Income Per Share: Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding. Diluted net income per share is based on the weighted-average number of common shares outstanding, plus common share equivalents calculated for stock options and restricted common stock outstanding using the treasury stock method.

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: In March 2006, the Financial Accounting Standards Board (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. The standard's adoption effective January 1, 2007 did not have a material effect on Capitol's consolidated financial statements.

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,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

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. FIN 48 did not have a material effect on Capitol's consolidated financial statements upon implementation effective January 1, 2007.

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 and expands related financial statement disclosures. 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. The effect of these new standards' adoption is not expected to be material. Statement No. 157 does not require any new fair value measurements and was initially effective for the Corporation beginning January 1, 2008. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2. FSP FAS 157-2 defers the effective date of SFAS No. 157 until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

In June 2007, the FASB ratified an Emerging Issues Task Force (EITF) consensus regarding *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards*, which becomes effective for Capitol January 1, 2008. Management expects the effect of this new guidance upon implementation will not be material to Capitol's consolidated financial statements.

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations*, to further enhance the accounting and financial reporting related to business combinations. Statement No. 141(R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, (2) recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase, (3) requires that acquisition-related and restructuring costs to be recognized separately from the acquisition, generally charged to expense when incurred and (4) determines information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Statement No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The effects of the Corporation's adoption of Statement No. 141(R) will depend upon the extent and magnitude of acquisitions after December 31, 2008.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE B—SIGNIFICANT ACCOUNTING POLICIES—Continued

Also in December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*, to create accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Statement No. 160 establishes accounting and reporting standards that require (1) the ownership interest in subsidiaries held by parties other than the parent to be clearly identified and presented in the consolidated balance sheet within equity, but separate from the parent's equity, (2) the amount of consolidated net income attributable to the parent and the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of income, (3) changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary to be accounted for consistently, (4) when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary to be initially measured at fair value and (5) entities provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. Statement No. 160 applies to fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, and early adoption is prohibited. Management has not completed its review of this new guidance.

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

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE C—INVESTMENT SECURITIES

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

	2007		2006	
	Amortized Cost	Estimated Market Value	Amortized Cost	Estimated Market Value
Available for sale:				
United States treasury securities	\$ 499	\$ 499		
United States government agency securities	8,991	9,025	\$ 13,403	\$ 13,285
Mortgage backed securities	3,402	3,368	4,089	3,991
Municipals	<u>1,222</u>	<u>1,227</u>	<u>1,630</u>	<u>1,628</u>
	14,114	14,119	19,122	18,904
Held for long-term investment:				
Federal Reserve Bank stock	563	563	864	864
Federal Home Loan Bank stock	18,765	18,765	14,148	14,148
Corporate	4,204	4,204	4,419	4,419
Other	<u>1,946</u>	<u>1,946</u>	<u>2,318</u>	<u>2,318</u>
	<u>25,478</u>	<u>25,478</u>	<u>21,749</u>	<u>21,749</u>
	<u>\$ 39,592</u>	<u>\$ 39,597</u>	<u>\$ 40,871</u>	<u>\$ 40,653</u>

At December 31, 2007, 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.

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

	2007		2006	
	Gains	Losses	Gains	Losses
United States government agency securities	\$ 38	\$ 4	\$ --	\$ 118
Mortgage backed securities	23	57	13	111
Municipals	<u>14</u>	<u>9</u>	<u>11</u>	<u>13</u>
	<u>\$ 75</u>	<u>\$ 70</u>	<u>\$ 24</u>	<u>\$ 242</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE C—INVESTMENT SECURITIES—Continued

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

	2007		2006	
	Unrealized Loss	Carrying Value	Unrealized Loss	Carrying Value
One year or less:				
United States government agency securities	\$ --	\$ --	\$ 7	\$ 3,488
Mortgage backed securities	--	--	--	--
Municipals	--	--	--	--
	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 7</u>	<u>\$ 3,488</u>
In excess of one year:				
United States government agency securities	\$ 4	\$ 1,552	\$ 111	\$ 9,297
Mortgage backed securities	57	2,823	111	3,444
Municipals	9	235	13	231
	<u>70</u>	<u>4,610</u>	<u>235</u>	<u>12,972</u>
	<u>\$ 70</u>	<u>\$ 4,610</u>	<u>\$ 242</u>	<u>\$ 16,460</u>

Management does not believe any individual unrealized loss as of December 31, 2007 represents an other-than-temporary loss (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.

Scheduled maturities of investment securities held as of December 31, 2007 were as follows (in \$1,000s):

	Amortized Cost	Estimated Market Value
Due in one year or less	\$ 2,220	\$ 2,218
After one year, through five years	6,145	6,175
After five years, through ten years	2,974	2,975
After ten years	2,775	2,751
Securities held for long-term investment, without standard maturities	25,478	25,478
	<u>\$ 39,592</u>	<u>\$ 39,597</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE D—LOANS

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

	<u>2007</u>	<u>2006</u>
Loans secured by real estate:		
Commercial	\$ 1,917,113	\$ 1,602,743
Residential (including multi-family)	698,960	529,357
Construction, land development and other land	<u>852,595</u>	<u>705,255</u>
Total loans secured by real estate	3,468,668	2,837,355
Commercial and other business-purpose loans	768,473	602,294
Consumer	48,041	39,957
Other	<u>29,519</u>	<u>9,072</u>
Total portfolio loans	4,314,701	3,488,678
Less allowance for loan losses	<u>(58,124)</u>	<u>(45,414)</u>
Net portfolio loans	<u>\$ 4,256,577</u>	<u>\$ 3,443,264</u>

Loans serviced for the benefit of others, which are not recorded on the consolidated balance sheet, approximated \$90 million and \$92 million at December 31, 2007 and 2006, respectively.

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

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Balance at January 1	\$ 45,414	\$ 40,559	\$ 37,572
Provision charged to operations	25,340	12,156	10,960
Net charge-offs:			
Loans charged off (deduction)	(14,219)	(8,699)	(9,643)
Recoveries	<u>1,589</u>	<u>1,398</u>	<u>1,670</u>
Net charge-offs	<u>(12,630)</u>	<u>(7,301)</u>	<u>(7,973)</u>
Balance at December 31	<u>\$ 58,124</u>	<u>\$ 45,414</u>	<u>\$ 40,559</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.

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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	
	2007	2006
Nonaccrual loans:		
Loans secured by real estate:		
Commercial	\$ 19,016	\$ 8,771
Residential (including multi-family)	13,381	6,808
Construction, land development and other land	<u>29,756</u>	<u>8,583</u>
Total loans secured by real estate	62,153	24,162
Commercial and other business-purpose loans	5,782	5,349
Consumer	66	215
Other	<u>84</u>	<u>--</u>
Total nonaccrual loans	68,085	29,726
Past due (≥90 days) loans:		
Loans secured by real estate:		
Commercial	113	1,380
Residential (including multi-family)	1,116	526
Construction, land development and other land	<u>2,531</u>	<u>1,116</u>
Total loans secured by real estate	3,760	3,022
Commercial and other business-purpose loans	714	1,375
Consumer	66	151
Other	<u>5</u>	<u>--</u>
Total past due loans	<u>4,545</u>	<u>4,548</u>
Total nonperforming loans	<u>\$ 72,630</u>	<u>\$ 34,274</u>

If nonperforming loans had performed in accordance with their contractual terms during the year, additional interest income of \$4.8 million, \$2.3 million and \$1.9 million would have been recorded in 2007, 2006 and 2005, respectively. Interest income recognized on loans in nonaccrual status in 2007, 2006 and 2005 operations approximated \$1,876,000, \$888,000 and \$845,000, respectively. At December 31, 2007, there were no material amounts of loans which were restructured or otherwise renegotiated as a concession to troubled borrowers.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE D—LOANS—Continued

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, 2007		December 31, 2006	
	Amount	Percentage of Total Portfolio Loans	Amount	Percentage of Total Portfolio Loans
Loans secured by real estate:				
Commercial	\$ 21,918	0.51%	\$ 17,886	0.51%
Residential (including multi-family)	10,235	0.24	7,234	0.21
Construction, land development and other land	<u>11,278</u>	<u>0.26</u>	<u>8,471</u>	<u>0.24</u>
Total loans secured by real estate	43,431	1.01	33,591	0.96
Commercial and other business-purpose loans	13,727	0.32	11,112	0.32
Consumer	667	0.01	558	0.02
Other	<u>299</u>	<u>0.01</u>	<u>153</u>	<u>0.00</u>
Total allowance for loan losses	<u>\$ 58,124</u>	<u>1.35%</u>	<u>\$ 45,414</u>	<u>1.30%</u>

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, 2007 and 2006, total loans to these persons were \$184 million and \$131 million, respectively. During 2007, \$146 million of new loans were made to these persons and repayments totaled \$93 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 \$210 million and \$171 million at December 31, 2007 and 2006, respectively, are accepted based upon the banks' normal terms as to interest rate, term and deposit insurance.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE F—PREMISES AND EQUIPMENT

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

	<u>2007</u>	<u>2006</u>
Land, buildings and improvements	\$ 20,064	\$ 19,891
Leasehold improvements	25,257	19,483
Equipment, furniture and software	<u>52,639</u>	<u>45,734</u>
	97,960	85,108
Less accumulated depreciation	<u>(37,929)</u>	<u>(30,813)</u>
	<u>\$ 60,031</u>	<u>\$ 54,295</u>

Capitol and certain subsidiaries rent office space under operating leases. Rent expense (net of sublease income) under these lease agreements approximated \$9.2 million, \$7.6 million and \$6.2 million in 2007, 2006 and 2005, respectively (including rent expense approximating \$1.6 million, \$1.5 million and \$1.7 million, respectively, under leases with related parties).

At December 31, 2007, 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):

2008	\$ 9,098
2009	8,486
2010	7,449
2011	7,164
2012	6,283
2013 and thereafter	<u>17,758</u>
	<u>\$ 56,238</u>

NOTE G—DEPOSITS

The aggregate amount of time deposits of \$100,000 or more approximated \$1.1 billion and \$960 million as of December 31, 2007 and 2006, respectively.

At December 31, 2007, the scheduled maturities of time deposits were as follows (in \$1,000s):

2008	\$ 1,524,347
2009	183,633
2010	57,963
2011	34,858
2012	18,746
2013 and thereafter	<u>1,570</u>
	<u>\$ 1,821,117</u>

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

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>2007</u>	<u>2006</u>
Borrowings from Federal Home		
Loan Banks	\$ 298,744	\$ 183,598
Federal funds purchased	20,850	6,997
Repurchase agreements	790	559
	<u>\$ 320,384</u>	<u>\$ 191,154</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, 2007). At December 31, 2007, unused lines of credit under these facilities approximated \$490 million. Assets pledged to secure these credit facilities approximated \$579 million at December 31, 2007.

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 (7% at December 31, 2007), payable monthly, and a quarterly facility fee on the unused portion. There were no amounts drawn on the line of credit at December 31, 2007 or 2006. 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.

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

At December 31, 2007, scheduled debt maturities of notes payable and short-term borrowings were as follows (in \$1,000s):

2008	\$ 176,234
2009	80,950
2010	47,750
2011	10,844
2012	4,500
2013 and thereafter	106
	<u>\$ 320,384</u>

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE I—SUBORDINATED DEBT

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

	Interest Rate at December 31, 2007	Scheduled Maturity	Aggregate Liquidation Amount (in \$1,000s)	Net Carrying Amount at December 31 (in \$1,000s)	
				2007	2006
Capitol Trust I	8.50% fixed	2027	\$ 25,300	\$ 24,579	\$ 24,543
Capitol Trust II	10.25% fixed	2031	10,000	9,763	9,753
Capitol Statutory Trust III	8.54% variable	2031	15,000	14,645	14,630
Capitol Trust IV	7.91% variable	2032	3,000	2,918	2,914
Capitol Trust VI	8.54% variable	2033	10,000	9,748	9,738
Capitol Trust VII	7.78% fixed	2033	10,000	9,871	9,866
Capitol Statutory Trust VIII	7.94% variable	2033	20,000	19,663	19,650
Capitol Trust IX	7.69% fixed	2034	10,000	9,943	9,941
Capitol Trust X	6.55% fixed	2037	35,000	35,000	
Capitol Trust XI	6.64% variable	2037	20,000	20,000	
			<u>\$ 158,300</u>	<u>\$ 156,130</u>	<u>\$ 101,035</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.

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 \$1.6 million in 2007, \$1.7 million in 2006 and \$1.2 million in 2005. Tax benefits associated with such compensation expense approximated \$436,000 in 2007, \$351,000 in 2006 and \$229,000 in 2005. Future compensation expense related to unvested restricted common stock as of December 31, 2007 approximates \$3.7 million (based on grants through December 31, 2007), to be recorded ratably over a period of approximately 3.5 years, based on the weighted-average remaining vesting period at that date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE J—RESTRICTED COMMON STOCK AND STOCK OPTIONS—Continued

Restricted share activity is summarized below:

	2007		2006		2005	
	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	224,416	\$ 27.72	200,631	\$ 21.76	258,978	\$ 21.91
Granted	43,972	21.55	80,750	38.69	--	--
Vested	(58,966)	22.28	(56,965)	22.27	(58,347)	22.43
Forfeited	(2,000)	44.56	--	--	--	--
Unvested at December 31	<u>207,422</u>	<u>\$ 27.80</u>	<u>224,416</u>	<u>\$ 27.72</u>	<u>200,631</u>	<u>\$ 21.76</u>

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, 2005	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	(41,338)			
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	--			
Outstanding at December 31, 2006	2,570,091	10.81	to 37.48	26.86
Granted in 2007	168,720	22.46	46.20	25.09
Exercised in 2007	(277,149)	10.81	to 33.01	16.98
Cancelled or expired in 2007	(1,580)			
Outstanding at December 31, 2007	<u>2,460,082</u>	\$13.50	to \$46.20	<u>\$27.85</u>

The aggregate intrinsic value of exercised options approximated \$4.7 million, \$8.3 million and \$12.7 million in 2007, 2006 and 2005, respectively.

Stock options with an aggregate fair value of \$1,102,000 were granted in 2007. Fair value was computed using the Black-Scholes valuation model. Fair value assumptions included a risk-free interest rate of 4.6%, stock price volatility of .37, dividend yield of 4.5% and an expected option life of 7 years. Compensation expense related to such stock options

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE J—RESTRICTED COMMON STOCK AND STOCK OPTIONS—Continued

approximated \$410,000 in 2007 and associated tax benefits approximated \$144,000. Future compensation expense relating to stock options as of December 31, 2007 approximates \$692,000 (based on grants subject to FASB Statement 123(R) through December 31, 2007) and will be recorded ratably over a period of 2.6 years, based on the weighted-average remaining vesting period at that date.

As of December 31, 2007, substantially all outstanding stock options were vested, currently exercisable and had a weighted average remaining contractual life of 3.4 years (excluding certain stock options granted in 2007 which are not vested and are not currently exercisable). The following table summarizes stock options outstanding segregated by exercise price range:

Exercise Price Range	Number Outstanding	Weighted Average		Aggregate Intrinsic Value
		Exercise Price	Remaining Contractual Life	
\$10.00 to 14.99	7,587	\$12.12	0.07 years	\$ 60,696
\$15.00 to 19.99	232,688	16.59	2.10 years	821,389
\$20.00 to 24.99	570,198	21.78	3.33 years	0
\$25.00 to 29.99	586,987	27.09	2.64 years	0
\$30.00 to 34.99	695,115	32.10	3.69 years	0
\$35.00 or more	<u>367,507</u>	37.92	4.92 years	<u>0</u>
	<u>2,460,082</u>			<u>\$ 882,085</u>

Cash received upon exercise of stock options approximated \$3.7 million, \$5.1 million and \$4.2 million and tax benefits realized approximated \$1.3 million, \$2.1 million and \$1.8 million in 2007, 2006 and 2005, respectively.

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, 2007, 2006 and 2005 were \$2.2 million, \$1.5 million and \$1.1 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 2007, 2006 and 2005 approximated \$1,324,000, \$1,134,000 and \$949,000, respectively. As of December 31, 2007, the ESOP held approximately 350,000 shares of Capitol's common stock which have been allocated to participants' accounts; there were no unallocated shares as of that date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE L—INCOME TAXES

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

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Federal:			
Currently payable	\$ 13,003	\$ 21,367	\$ 22,326
Deferred (credit)	<u>(10,397)</u>	<u>(5,493)</u>	<u>(5,263)</u>
	2,606	15,874	17,063
State income taxes (credit)	<u>218</u>	<u>(411)</u>	<u>2,169</u>
	<u>\$ 2,824</u>	<u>\$ 15,463</u>	<u>\$ 19,232</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 \$1.5 million in 2007 (\$1.2 million in 2006 and \$1.3 million in 2005), and is excluded from income tax expense (included as a component of other noninterest expense).

Federal income taxes paid in 2007, 2006 and 2005 approximated \$10.1 million, \$20.9 million and \$19.3 million, respectively. State income taxes approximating \$735,000 were paid in 2007, \$928,000 was received in refunds for a net refund of \$193,000 (\$1.8 million was paid in 2006 and \$1.9 million in 2005). Federal income taxes payable at December 31, 2007 and 2006 were reduced by tax benefits approximating \$1.9 million and \$2.1 million, respectively, arising from the exercise of stock options.

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

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Federal income tax computed at statutory rate of 35%	\$ 2,155	\$ 15,869	\$ 17,381
State income taxes (credit)	218	(411)	2,169
Federal tax effect of:			
Amortization of intangibles	54	205	202
State income taxes	(76)	144	(759)
Other	<u>473</u>	<u>(344)</u>	<u>239</u>
	<u>\$ 2,824</u>	<u>\$ 15,463</u>	<u>\$ 19,232</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE L—INCOME TAXES—Continued

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

	<u>2007</u>	<u>2006</u>
Allowance for loan losses	\$ 20,134	\$ 15,099
Net operating losses of subsidiaries	14,247	8,202
Deferred compensation	2,890	2,635
Depreciation	(2,843)	(2,136)
Start-up costs for <i>de novo</i> banks	4,463	2,730
Market value adjustment for investment securities available for sale	14	74
Other, net	<u>(3,593)</u>	<u>(1,629)</u>
	<u>\$ 35,312</u>	<u>\$ 24,975</u>

Certain subsidiaries (generally less than 80%-owned entities) 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, 2007, expire at the following dates and amounts (in \$1,000s):

2024	\$ 526
2025	5,977
2026	13,177
2027	<u>21,027</u>
	<u>\$ 40,707</u>

In conjunction with implementation of FIN 48 effective January 1, 2007 (see Note B), management concluded that there were no significant uncertain tax positions requiring recognition in the consolidated financial statements. The evaluation was performed for the tax years ended 2003, 2004, 2005 and 2006, the tax years which remain subject to examination by major tax jurisdictions and was updated as of December 31, 2007.

The Internal Revenue Service commenced and completed an examination of the Corporation's consolidated federal income tax return for the year ended December 31, 2005 during 2007. No significant adjustments to taxable income or taxes due arose from that examination.

Capitol may from time to time be assessed interest or penalties associated with tax liabilities by major tax jurisdictions, although any such assessments are estimated to be minimal and immaterial. To the extent Capitol has received an assessment for interest and/or penalties, it has been classified in the consolidated statements of income as a component of other noninterest expense.

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>2007</u>	<u>2006</u>	<u>2005</u>
Numerator—net income	<u>\$ 21,937</u>	<u>\$ 42,391</u>	<u>\$ 35,925</u>
Denominator:			
Weighted average number of shares outstanding, excluding unvested restricted shares (denominator for basic earnings per share)	16,967	15,772	14,867
Effect of dilutive securities:			
Unvested restricted shares	70	86	86
Stock options	<u>179</u>	<u>623</u>	<u>412</u>
Potential dilution	<u>249</u>	<u>709</u>	<u>498</u>
Denominator for diluted earnings per share—weighted average number of shares and potential dilution	<u>17,216</u>	<u>16,481</u>	<u>15,365</u>
Number of antidilutive stock options excluded from diluted earnings per share computation	<u>1,063</u>	<u>--</u>	<u>1,085</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):

	2007		2006	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 352,372	\$ 352,372	\$ 348,870	\$ 348,870
Loans held for sale	16,419	16,419	34,593	34,593
Investment securities:				
Available for sale	14,119	14,119	18,904	18,904
Held for long-term investment	<u>25,478</u>	<u>25,478</u>	<u>21,749</u>	<u>21,749</u>
	39,597	39,597	40,653	40,653
Portfolio loans:				
Loans secured by real estate:				
Commercial	1,917,113	1,923,373	1,602,743	1,598,643
Residential (including multi-family)	698,960	699,216	529,357	527,563
Construction, land development and other land	<u>852,595</u>	<u>854,965</u>	<u>705,255</u>	<u>702,873</u>
Total loans secured by real estate	3,468,668	3,477,554	2,837,355	2,829,079
Commercial and other business-purpose loans				
	768,473	774,043	602,294	598,684
Consumer	48,041	48,983	39,957	38,116
Other	<u>29,519</u>	<u>30,421</u>	<u>9,072</u>	<u>8,978</u>
Total portfolio loans	4,314,701	4,331,001	3,488,678	3,474,857
Less allowance for loan losses	<u>(58,124)</u>	<u>(58,124)</u>	<u>(45,414)</u>	<u>(45,414)</u>
Net portfolio loans	4,256,577	4,272,877	3,443,264	3,429,443
Financial Liabilities:				
Deposits:				
Noninterest-bearing				
	671,688	671,688	651,253	651,253
Interest-bearing:				
Demand accounts				
	1,351,940	1,351,939	1,186,999	1,187,320
Time certificates of less than \$100,000				
	753,912	753,817	460,203	461,145
Time certificates of \$100,000 or more				
	<u>1,067,205</u>	<u>1,069,111</u>	<u>960,030</u>	<u>961,649</u>
Total interest-bearing	<u>3,173,057</u>	<u>3,174,867</u>	<u>2,607,232</u>	<u>2,610,114</u>
Total deposits	3,844,745	3,846,555	3,258,485	3,261,367
Notes payable and short-term borrowings	320,384	320,038	191,154	191,713
Subordinated debentures	156,130	158,300	101,035	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 (\$28.8 million and \$32.3 million outstanding at December 31, 2007 and 2006, respectively). Other loan commitments outstanding consist of unused lines of credit and approved, but unfunded, specific loan commitments (\$1 billion and \$794 million at December 31, 2007 and 2006, 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, 2007 and 2006 was \$6.3 million and \$6.7 million, respectively.

Deposits at each of the banks are insured up to the maximum amount covered by FDIC insurance. Some of the banks have municipal government deposits which are guaranteed by Capitol (\$20 million at December 31, 2007).

Capitol has guaranteed up to \$2.5 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, 2007, 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, 2007, that Capitol and its 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	
	2007	2006
Tier 1 capital to average adjusted total assets:		
Minimum required amount	≥\$188,551	≥\$155,110
Actual amount	\$628,747	\$527,355
Ratio	13.34%	13.60%
Tier 1 capital to risk-weighted assets:		
Minimum required amount ⁽¹⁾	≥\$177,353	≥\$145,475
Actual amount	\$628,747	\$527,355
Ratio	14.18%	14.50%
Combined Tier 1 and Tier 2 capital to risk-weighted assets:		
Minimum required amount ⁽²⁾	≥\$354,706	≥\$290,949
Amount required to meet 'Well-Capitalized' category ⁽³⁾	≥\$443,382	≥\$363,687
Actual amount	\$684,204	\$572,816
Ratio	15.43%	15.75%

- (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-	
	2007	2006
	(in \$1,000s)	
Assets		
Cash on deposit principally with subsidiary banks	\$ 2,460	\$ 3,314
Money market funds on deposit principally with subsidiary banks	7,347	4,113
Time deposits principally with subsidiary banks	<u>9,377</u>	<u>10,406</u>
Cash and cash equivalents	19,184	17,833
Investment securities	3,321	4,048
Loans, net	28,242	11,314
Investments in and advances to subsidiaries	474,436	418,239
Investment in and advances to Amera Mortgage Corporation	482	482
Equipment, software and furniture, net	10,320	9,332
Other assets	<u>23,960</u>	<u>13,206</u>
Total assets	<u>\$ 559,945</u>	<u>\$ 474,454</u>
Liabilities and Stockholders' Equity		
Accounts payable, accrued expenses and other liabilities	\$ 9,770	\$ 8,342
Subordinated debentures	<u>161,030</u>	<u>104,233</u>
Total liabilities	170,800	112,575
Stockholders' equity	<u>389,145</u>	<u>361,879</u>
Total liabilities and stockholders' equity	<u>\$ 559,945</u>	<u>\$ 474,454</u>

Condensed Statements of Income

	-Year Ended December 31-		
	2007	2006	2005
	(in \$1,000s)		
Income:			
Dividends from subsidiaries	\$ 32,750	\$ 30,475	\$ 34,350
Intercompany fees	24,854	23,039	19,458
Interest	610	199	816
Other	<u>2,021</u>	<u>943</u>	<u>1,413</u>
Total income	60,235	54,656	56,037
Expenses:			
Interest	12,174	8,896	7,976
Salaries and employee benefits	11,756	10,482	13,325
Occupancy	2,049	1,584	1,249
Amortization, equipment rent and depreciation	3,499	2,146	1,839
Other	<u>8,800</u>	<u>1,606</u>	<u>3,153</u>
Total expenses	<u>38,278</u>	<u>24,714</u>	<u>27,542</u>
Income before equity in undistributed net earnings (losses) of consolidated subsidiaries and income tax credit	21,957	29,942	28,495
Equity in undistributed net earnings (losses) of consolidated subsidiaries	<u>(4,469)</u>	<u>11,773</u>	<u>6,171</u>
Income before income tax credit	17,488	41,715	34,666
Income tax credit	<u>(4,449)</u>	<u>(676)</u>	<u>(1,259)</u>
Net income	<u>\$ 21,937</u>	<u>\$ 42,391</u>	<u>\$ 35,925</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-		
	2007	2006 (in \$1,000s)	2005
OPERATING ACTIVITIES			
Net income	\$ 21,937	\$ 42,391	\$ 35,925
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Equity in undistributed net earnings (losses) of subsidiaries	4,469	(11,773)	(6,171)
Depreciation and amortization of intangibles	2,189	1,459	1,245
Loss on sale of equipment and furniture		3	3
Decrease (increase) in amounts due from subsidiaries and other assets	(31,716)	23,388	7,938
Increase (decrease) in accounts payable, accrued expenses and other liabilities	1,428	(3,214)	1,772
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	<u>(1,693)</u>	<u>52,254</u>	<u>40,712</u>
INVESTING ACTIVITIES			
Net cash investments in subsidiaries	(16,830)	(36,193)	(31,723)
Net payments from Amera Mortgage Corporation			315
Purchases of investment securities		(2,000)	(673)
Net increase in loans	(16,928)	(8,449)	(1,635)
Proceeds from sales of equipment and furniture	126		4
Purchases of equipment and furniture	(3,170)	(5,098)	(4,034)
NET CASH USED BY INVESTING ACTIVITIES	<u>(36,802)</u>	<u>(51,740)</u>	<u>(37,746)</u>
FINANCING ACTIVITIES			
Net proceeds from issuance of common stock	2,836	3,573	2,510
Net proceeds from issuance of subordinated debentures	55,000		
Tax benefit from share-based payments	1,688	2,481	
Acquisition of shares for employee benefit trust	(2,482)		
Cash dividends paid	(17,196)	(15,165)	(10,848)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	<u>39,846</u>	<u>(9,111)</u>	<u>(8,338)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>1,351</u>	<u>(8,597)</u>	<u>(5,372)</u>
Cash and cash equivalents at beginning of year	<u>17,833</u>	<u>26,430</u>	<u>31,802</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 19,184</u>	<u>\$ 17,833</u>	<u>\$ 26,430</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capitol Bancorp Limited

NOTE R—ACQUISITION OF MINORITY INTERESTS

During February of 2007, a share-exchange transaction was completed, whereby approximately 371,000 shares of Capitol common stock were exchanged for minority interests in Capitol Development Bancorp Limited II.

Had these acquisitions occurred at the beginning of 2006, unaudited pro forma consolidated net income would have approximated \$21.7 million in 2007 and \$41.4 million in 2006 and diluted earnings per share would have been \$1.24 in 2007 and \$2.46 in 2006.

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.

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