BERKSHIRE BANCORP INC /DE/
Form 10-K
March 09, 2006

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

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________________ to ________________

Commission File Number 0-13649

Berkshire Bancorp Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-2563513 (I.R.S. employer identification number)
160 Broadway, New York, New York (Address of principal executive offices)	10038 (Zip Code)

Registrant's telephone number, including area code: (212) 791-5362

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

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $.10 per share
(Title of Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.) Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act. Yes [ ] No [X]

Aggregate market value of voting and non-voting common stock held by non-affiliates of the Registrant as of June 30, 2005: $54,923,612.

Number of shares of Common Stock outstanding as of February 20, 2006: 6,890,556.

DOCUMENTS INCORPORATED BY REFERENCE:

None

Forward-Looking Statements. Statements in this Annual Report on Form 10-K that are not based on historical fact may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "believe", "may", "will", "expect", "estimate", "anticipate", "continue" or similar terms identify forward-looking statements. A wide variety of factors could cause the Company's actual results and experiences to differ materially from the results expressed or implied by the Company's forward-looking statements. Some of the risks and uncertainties that may affect operations, performance, results of the Company's business, the interest rate sensitivity of its assets and liabilities, and the adequacy of its loan loss allowance, include, but are not limited to: (i) deterioration in local, regional, national or global economic conditions which could result, among other things, in an increase in loan delinquencies, a decrease in property values, or a change in the housing turnover rate; (ii) changes in market interest rates or changes in the speed at which market interest rates change; (iii) changes in laws and regulations affecting the financial services industry; (iv) changes in competition; (v) changes in consumer preferences; (vi) changes in banking technology; (vii) ability to maintain key members of management; (viii) possible disruptions in the Company's operations at its banking facilities; (ix) cost of compliance with new corporate governance requirements; and other factors referred to in the sections of this Annual Report entitled "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Certain information customarily disclosed by financial institutions, such as estimates of interest rate sensitivity and the adequacy of the loan loss allowance, are inherently forward-looking statements because, by their nature, they represent attempts to estimate what will occur in the future.

The Company cautions readers not to place undue reliance upon any forward- looking statement contained in this Annual Report. Forward-looking statements speak only as of the date they were made and the Company assumes no obligation to update or revise any such statements upon any change in applicable circumstances.

PART I

ITEM 1. Business

General. Berkshire Bancorp Inc., a Delaware corporation , is a bank holding company registered under the Bank Holding Company Act of 1956. As used in this Annual Report on Form 10-K, the term "Berkshire", the "Company" or "we" and similar pronouns shall mean Berkshire Bancorp Inc. and its consolidated subsidiaries unless the context otherwise requires. Berkshire's principal activity is the ownership and management of its wholly-owned banking subsidiary, The Berkshire Bank (the "Bank"), a New York State chartered commercial bank.

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy our reports or other filings made with the SEC at the SEC's Public Reference Room, located at 450 Fifth Street, N.W., Washington, DC 20549. You can also access information that we file electronically on the SEC's website at WWW.SEC.GOV.

We do not presently have a website. However, as soon as practicable after filing with or furnishing to the SEC, we will provide at no cost, paper or electronic copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports. Requests should be directed to:

Berkshire Bancorp Inc.
Investor Relations
160 Broadway
New York, NY 10038

Stock Split and Stock Dividend. At the Annual Meeting of Stockholders held on May 18, 2004, the Company's stockholders approved an amendment to the Company's Certificate of Incorporation effecting a one-for-ten reverse stock split of the Company's issued and outstanding Common Stock (the "Reverse Split"). Following the effectiveness of the Reverse Split, the Company's Board of Directors declared a thirty-for-one forward stock split in the form of a stock dividend in Common Stock (the "Stock Dividend) which became effective immediately. The Company paid approximately $463,000 to purchase fractional shares from stockholders as part of the Reverse Split. The Company's Common Stock began trading on May 19, 2004 giving effect to these transactions.

Trust Preferred Securities. As of May 18 2004, the Company established Berkshire Capital Trust I, a Delaware statutory trust, ("BCTI"). The Company owns all the common capital securities of BCTI. BCTI issued $15.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTI's common capital securities, in the Company through the purchase of $15.464 million aggregate principal amount of Floating Rate Junior Subordinated Debentures (the

"Debentures") issued by the Company. The Debentures, the sole assets of BCTI, mature on July 23, 2034 and bear interest at a floating rate, three month LIBOR plus 2.70%.

On April 1, 2005, the Company established Berkshire Capital Trust II, a Delaware statutory trust, ("BCTII"). The Company owns all the common capital securities of BCTII. BCTII issued $7.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTII's common capital securities, in the Company through the purchase of $7.217 million aggregate principal amount of Floating Rate Junior Subordinated Debentures (the "2005 Debentures") issued by the Company. The 2005 Debentures, the sole assets of BCTII, mature on May 23, 2035 and bear interest at a floating rate, three month LIBOR plus 1.95%. See Note A of Notes to Consolidated Financial Statements for further discussion of Trust Preferred Securities.

Business of the Bank - General. The Bank's principal business consists of gathering deposits from the general public and investing those deposits primarily in loans, debt obligations issued by the U.S. Government and its agencies, debt obligations of business corporations, and mortgage-backed securities. The Bank currently operates from six deposit-taking offices in New York City and four deposit-taking offices in Orange and Sullivan Counties, New York.

Branch Locations of The Berkshire Bank
December 31, 2005

4 East 39th Street New York, NY	2 South Church Street Goshen, NY
5 Broadway New York, NY	214 Harriman Drive Goshen, NY
5010 13th Avenue Brooklyn, NY	80 Route 17M Harriman, NY
1421 Kings Highway Brooklyn, NY	60 Main Street Bloomingburg, NY
4917 16th Avenue Brooklyn, NY	1119 Avenue J Brooklyn, NY

In September 2005, the Bank entered into a Branch Purchase and Deposit Assumption Agreement (the "Agreement") with the Oritani Savings Bank ("Oritani"), a New Jersey Chartered Savings Bank. Pursuant to the Agreement, the Bank will (i) assume certain commercial checking account deposit liabilities and (ii) purchase certain fixed assets and the real property of this Oritani bank branch located in Ridgefield, New Jersey for a cash purchase price of $850,000. Upon the closing of the transaction, which has received all of the required regulatory approvals, among other things, the Bank intends to open a branch of The Berkshire Bank at the Ridgefield, New Jersey location in May 2006.

In August 2005, the Bank formed Berkshire 1031 Exchange, LLC ("Berkshire 1031"), a wholly owned limited liability company. Berkshire 1031 will act as a qualified intermediary in connection with tax free exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended. A qualified intermediary is an individual or business entity that assists owners of property who wish to exchange their property for property of a "like-kind" in a transaction that is tax free in whole or part for federal (and in some cases state) income tax purposes. In accordance with detailed procedures set forth in federal income tax regulations, Berkshire 1031 will assist the owner in the sale of the owner's property and the purchase of replacement property so that the transaction qualifies as a non-taxable exchange of property.

The Bank's principal loan types are residential and commercial mortgage loans and commercial non-mortgage loans, both unsecured and secured by personal property. The Bank's revenues come principally from interest on loans and investment securities. The Bank's primary sources of funds are deposits and proceeds from principal and interest payments on loans and investment securities.

Operating Plan. The Bank's operating plan concentrates on obtaining deposits from a variety of businesses, professionals and retail customers and investing those funds in conservatively underwritten loans. Due to the Bank's underwriting criteria, its deposits have significantly exceeded the level of satisfactory loans available for investment in recent years. Hence, the Bank has, in recent years, invested a portion of its available funds in investment and mortgage-backed securities.

Market Area. The Bank draws its customers principally from the New York City metropolitan area and, since the merger with Goshen Savings Bank ("Goshen Bank") in 2001, the Villages of Goshen and Harriman, New York and their surrounding communities, representing most of Orange County, NY. The Bank also has a branch in Bloomingburg, New York, just over the border between Orange and Sullivan Counties. Predominantly rural with numerous small towns, many residents of Orange and Sullivan Counties work in New York City. Consequently, the health of the economy in the New York City metropolitan area has, and will continue to have a direct effect on the economic well being of residents and businesses in these counties. Upon the completion of the transaction with Oritani, the Bank's market area will expand into northern New Jersey. From time to time, the Bank may make loans or accept deposits from outside these areas, but such transactions generally represent outgrowths of existing local customer relationships.

Competition. The Bank's principal competitors for deposits are other commercial banks, savings banks, savings and loan associations and credit unions in the Bank's market areas, as well as money market mutual funds, insurance companies, securities brokerage firms and other financial institutions, many of which are substantially larger in size than the Company. The Bank's competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage bankers, finance companies and other institutional lenders. Many of the institutions which compete with the Bank have much greater financial and marketing resources than the Bank. The Bank's principal methods of competition include loan and deposit pricing, maintaining close ties with its local communities, the quality of the personal service it provides, the types of business services it provides, and other marketing programs.

Operations of the Bank. Reference is made to the information set forth in Item 7 herein ("Management's Discussion and Analysis of Financial Condition and Results of Operations") for information as to various aspects of the Bank's operations, activities and conditions.

In March, 2001, pursuant to the terms of an Agreement and Plan of Reorganization dated August 16, 2000 (the "GSB Agreement"), we completed the merger with GSB Financial Corporation, a Delaware corporation, a savings and loan holding company ("GSB Financial"), and its wholly-owned subsidiary, Goshen Bank, a federal savings bank, chartered and existing under the laws of the United States. GSB Financial was merged with and into Berkshire and Goshen Bank was merged with and into The Berkshire Bank. Holders of the common stock of GSB Financial received $20.75 in cash for each share of common stock of GSB Financial held by them, or, in the alternative, at their election, 0.6027 shares of Berkshire's common stock. As a result of this transaction, 978,032 shares of GSB Financial common stock were converted into 589,460 shares of Berkshire common

stock, and 974,338 shares of GSB Financial common stock were purchased for $20.75 per share, totaling approximately $20.2 million.

This transaction was accounted for under the purchase method of accounting. Goodwill of $7.5 million was recorded in the transaction. Effective January 1, 2002, we adopted Statement of Financial Accounting Standard No. 142, Goodwill and Intangible Assets which eliminates the amortization of goodwill and requires an annual impairment test. As of December 31, 2005, we have completed the impairment testing of our intangible assets, including goodwill. We did not identify any impairment on our outstanding goodwill.

Subsidiary Activities. The Bank is permitted under New York State law and federal law to own subsidiaries for certain limited purposes, generally to engage in activities which are permissible for a subsidiary of a national bank. The Bank has two subsidiaries, Berkshire Agency, Inc., a company engaged in the title insurance agency business, and Berkshire 1031, a company that acts as a qualified intermediary in connection with tax free exchanges under Section 1031 of the Internal Revenue Service Code.

Regulation. Berkshire is a bank holding company under federal law and registered as such with the Federal Reserve. The Bank is a commercial bank chartered under the laws of New York State. It is subject to regulation at the state level by the New York Superintendent of Banks and the New York Banking Board, while at the federal level its primary regulator is the Federal Deposit Insurance Corporation (the "FDIC").

Both Berkshire and the Bank are subject to extensive state and federal regulation of their activities. The following discussion summarizes certain banking laws and regulations that affect Berkshire and the Bank. Proposals to change these laws and regulations are frequently proposed in Congress, in the New York State legislature, and before state and federal bank regulatory agencies. The likelihood and timing of any changes and the impact such changes might have on the Company are impossible to determine with any certainty. A change in applicable laws or regulations, or a change in the way such laws or regulations are interpreted by regulatory agencies or courts, may have a material impact on the business, operations and earnings of the Company, the nature and effect of which cannot be predicted.

Bank Holding Company Regulation. The Federal Reserve is authorized to make regular examinations of the Company and its nonbank subsidiaries. Under federal law and Federal Reserve regulations, the activities in which the Company and its nonbank subsidiaries may engage are limited. The Company may not acquire direct or indirect ownership or control of more than 5% of the voting shares of any company, including a bank, without the prior approval of the Federal Reserve, except as specifically authorized under federal law and Federal Reserve regulations. The Company, subject to the approval of the Federal Reserve, may acquire more than 5% of the voting shares of non-banking corporations if those corporations engage in activities which the Federal Reserve deems to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. These limitations also apply to activities in which the Company engages directly rather than through a subsidiary.

The Federal Reserve has enforcement powers over the Company and its non- bank subsidiaries. This allows the Federal Reserve, among other things, to stop activities that represent unsafe or unsound practices or constitute violations of law, rules, regulations, administrative orders or written agreements with a federal bank regulator. These powers may be exercised through the issuance of cease-and-desist orders, the imposition of civil money penalties or other actions.

Federal Reserve Capital Requirements. The Federal Reserve requires that the Company, as a bank holding company, must maintain certain minimum ratios of capital to assets. The Federal Reserve's regulations divide capital into two categories. Primary capital includes common equity, surplus, undivided profits, perpetual preferred stock, mandatory convertible instruments, the allowance for loan and lease losses, contingency and other capital reserves, and minority interests in equity accounts of consolidated subsidiaries. Secondary capital includes limited-life preferred stock, subordinated notes and debentures and certain unsecured long term debt.

The Federal Reserve requires that bank holding companies maintain a minimum ratio of primary capital to total assets of 5.5% and a minimum level of total capital (primary plus secondary capital) equal to 6% of total assets. In calculating capital ratios, the allowance for loan losses, which is a component of primary capital, is added back in determining total assets. Certain capital components, such as debt and perpetual preferred stock, are includable as capital only if they satisfy certain definitional tests.

The Company must also meet a risk-based capital standard. Capital, for the risk-based capital requirement, is divided into Tier I capital and Supplementary capital, determined as discussed below in connection with the FDIC capital requirements imposed on the Bank. The Federal Reserve requires that the Bank maintain a ratio of total capital (defined as Tier I plus Supplementary capital) to risk-weighted assets of at least 8%, of which at least 4% must be Tier I capital. Risk weighted assets are also determined in a manner comparable to the determination of risk-weighted assets under FDIC regulations as discussed below.

At December 31, 2005 and 2004, the Company met the definition of a "well capitalized" bank holding company.

Inter-state Banking. Bank holding companies may generally acquire banks in any state. Federal law also permits a bank to merge with an out-of-state bank and convert any offices into branches of the resulting bank if both states have not opted out of interstate branching; permits a bank to acquire branches from an out-of-state bank if the law of the state where the branches are located permits the interstate branch acquisition; and permits banks to establish and operate new interstate branches whenever the host state opts-in to that authority. Bank holding companies and banks that want to engage in such activities must be adequately capitalized and managed.

The New York Banking Law generally authorizes interstate branching in New York as a result of a merger, purchase of assets or similar transaction. An out of state bank may not first enter New York by opening a new branch in New York, but once a branch is acquired as described in the preceding sentence, additional new branches may be opened state wide.

Regulation of the Bank. In general, the powers of the Bank are limited to the express powers described in the New York Banking Law and powers incidental to the exercise of those express powers. The Bank is generally authorized to accept deposits and make loans on terms and conditions determined to be acceptable to the Bank. Loans may be unsecured, secured by real estate, or secured by personal property. The Bank may also invest assets in bonds, notes or other debt securities which are not in default and certain limited classes of equity securities including certain publicly traded equity securities in an amount aggregating not more than 2% of assets or 20% of capital. The Bank may also engage in a variety of other traditional activities for commercial banks, such as the issuance of letters of credit.

The exercise of these state-authorized powers is limited by FDIC regulations and other federal laws and regulations. In particular, FDIC regulations limit the investment activities of state-chartered, FDIC-insured banks such as the Bank.

Under FDIC regulations, the Bank generally may not directly or indirectly acquire or retain any equity investment that is not permissible for a national bank. In addition, the Bank may not directly or indirectly through a subsidiary, engage as "principal" in any activity that is not permissible for a national bank unless the FDIC has determined that such activities would pose no risk to the applicable FDIC insurance fund and the Bank is in compliance with applicable regulatory capital requirements. FDIC regulations permit real estate investments under certain circumstances. The Bank does not engage in real estate investing activity.

Loans to One Borrower. With certain exceptions, the Bank may not make loans or other extensions of credit to a single borrower, or certain related groups of borrowers, in an aggregate amount in excess of 15% of the Bank's net worth, plus an additional 10% of the Bank's net worth if such amount is secured by certain types of readily marketable collateral. In addition, the Bank is not permitted to make a mortgage loan in excess of 15% of capital stock, surplus fund and undivided profits.

FDIC Capital Requirements. The FDIC requires that the Bank maintain certain minimum ratios of capital to assets. The FDIC's regulations divide capital into two tiers. The first tier ("Tier I") includes common equity, retained earnings, certain non-cumulative perpetual preferred stock (excluding auction rate issues) and minority interests in equity accounts of consolidated subsidiaries, minus goodwill and other intangible assets (except mortgage servicing rights and purchased credit card relationships subject to certain limitations). Supplementary ("Tier II") capital includes, among other items, cumulative perpetual and long-term limited-life preferred stock, mandatory convertible securities, certain hybrid capital instruments, term subordinated debt and the allowance for loan, subject to certain limitations, less required deductions.

The FDIC requires that the highest rated banks maintain a Tier I leverage ratio (Tier I capital to adjusted total assets) of at least 3.0%. All other banks subject to FDIC capital requirements must maintain a Tier I leverage ratio of 4.0% to 5.0% or more. As of December 31, 2005 and 2004, the Bank's Tier I leverage capital ratio was 10.1% and 8.6%, respectively.

The Bank must also meet a risk-based capital standard. The risk-based standard requires the Bank to maintain total capital (defined as Tier I and Supplementary capital) to risk-weighted assets of at least 8%, of which at least 4% must be Tier I capital. In determining the amount of risk-weighted assets, all assets, plus certain off-balance sheet assets, are multiplied by a risk-weight of 0% to 100%, based on the risks the FDIC believes are inherent in the type of asset. As of December 31, 2005 and 2004, the Bank maintained a 22.1% and 23.3% Tier I risk-based capital ratio and a 23.0% and 24.1% total risk-based capital ratio, respectively.

In addition to the foregoing regulatory capital requirements, the FDIC Improvements Act of 1991 created a "prompt corrective action" framework, under which decreases in a depository institution's capital category trigger various supervisory actions. Pursuant to implementing regulations adopted by the FDIC, for purposes of the prompt corrective action provisions, a state-chartered, nonmember bank, such as the Bank, is deemed to be well capitalized if it has: a total risk-based capital ratio of 10% or greater; a Tier I risk-based capital ratio of 6% or greater; and a leverage ratio of 5% or greater. As of December 31, 2005 and 2004, the Bank met the definition of a "well capitalized" financial institution.

Community Reinvestment Act. The Bank must, under federal law, meet the credit needs of its community, including low and moderate income segments of its community. The FDIC is required, in connection with its examination of the Bank, to assess whether the Bank has satisfied this requirement. Failure to satisfy this requirement could adversely affect certain applications which the Bank may make, such as branch applications, merger applications, and applications for permission to purchase branches. In the case of Berkshire, the Federal Reserve will assess the record of each subsidiary bank in considering certain applications by Berkshire. The New York Banking Law contains similar provisions applicable to the Bank. As of the most recent Community Reinvestment Act examinations by the FDIC and the New York State Banking Department, the Bank received "satisfactory" ratings.

Dividends From the Bank to the Company. One source of funds for Berkshire to pay dividends to its stockholders is dividends from the Bank to Berkshire. Under the New York Banking Law, the Bank may pay dividends to Berkshire, without regulatory approval, equal to its net profits for the year in which the payment is made, plus retained net profits for the two previous years, subject to certain limits not generally relevant. The Bank's retained net profits for the 2004 and 2005 calendar years totaled approximately $10.86 million.

Under federal law, the Bank may not make any capital distribution to Berkshire, including any dividend or repurchase of the Bank's stock, if, after making such distribution, the Bank fails to meet the required minimum capital ratio requirements discussed below. The FDIC may prohibit the Bank from paying dividends if, in its opinion, the payment of dividends would constitute an unsafe or unsound practice.

Transactions With Related Parties. The Company, its direct non-banking subsidiaries and other companies controlled by stockholders who control the Company are affiliates, within the meaning of the Federal Reserve Act, of the Bank and its subsidiaries. The Bank's authority to engage in transactions with its "affiliates" is limited by Sections 23A and 23B of the Federal Reserve Act. Section 23A limits the aggregate amount of transactions with any individual affiliate to 10% of the capital and surplus of the Bank and also limits the aggregate amount of transactions with all affiliates to 20% of the Bank's capital and surplus. Extensions of credit to affiliates must be secured by certain specified collateral, and the purchase of low quality assets from affiliates is generally prohibited. Section 23B provides that certain transactions with affiliates, including loans and asset purchases, must be on terms and under circumstances, including credit standards, that are at least as favorable to the Bank as those prevailing at the time for comparable transactions with non- affiliated companies. In the absence of comparable transactions, such transactions may only occur under terms and circumstances, including credit standards, that in good faith would be offered to or would apply to non- affiliated companies.

The Bank may make loans to its and the Company's directors, executive officers, and 10% stockholders, as well as to entities controlled by them, subject to specific federal and state limits. Among other things, these loans must (a) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features and (b) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank's capital. In addition, extensions of credit in excess of certain limits must be approved by the Bank's Board of Directors. However, the Bank may make loans to executive officers, directors and principal stockholders on preferential terms, provided the extension of credit is made pursuant to a benefit or compensation program of the Bank that is widely available to employees of the Bank or its affiliates and does not give preference to any insider over other employees of the Bank or affiliate. The Bank has no such benefit or compensation programs.

Enforcement. The FDIC and the Banking Department have enforcement authority over the Bank. The Superintendent may order the Bank to appear and explain an apparent violation of law, to discontinue unauthorized or unsafe practices and to keep prescribed books and accounts. If any director or officer of the Bank has violated any law, or has continued unauthorized or unsafe practices in conducting the business of the Bank after having been notified by the Superintendent to discontinue such practices, the New York Banking Board may remove the individual from office after notice and an opportunity to be heard. The Superintendent also may take over control of the Bank under specified statutory criteria.

The FDIC's enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease and desist orders and to remove directors and officers. As indicated above, the FDIC is required to take prompt action to correct deficiencies in banks which do not satisfy specified FDIC capital ratio requirements. Dividends, other capital distributions or the payment of management fees to any controlling person are prohibited if, following such distribution or payment, a bank would be undercapitalized. An undercapitalized bank must file a plan to restore its capital within 45 days after being notified that it is undercapitalized. Undercapitalized, significantly undercapitalized and critically undercapitalized institutions are subject to increasing prohibitions on permitted activities, and increasing levels of regulatory supervision, based upon the severity of their capital problems.

The FDIC is required to monitor closely the condition of an undercapitalized bank. Enforcement action taken by the FDIC can escalate to the appointment of a conservator or receiver of a critically undercapitalized bank.

Insurance of Accounts. Deposit insurance premiums payable to the FDIC are based upon the perceived risk of the institution to the FDIC insurance fund. The FDIC assigns an institution to one of three capital categories: (a) well capitalized, (b) adequately capitalized or (c) undercapitalized. The FDIC also assigns an institution to one of three supervisory categories based on an evaluation by the institution's primary federal regulator and information that the FDIC considers relevant to the institution's financial condition and the risk posed to the deposit insurance funds. Deposit insurance premiums depend on an institution's capital and supervisory categories. At present, the Bank pays no deposit insurance premium based upon its risk-based categorization.

However, the Bank must pay a share of the cost of the bonds issued in the late 1980s to recapitalize the now defunct Federal Savings and Loan Insurance Corporation. The Bank must pay an annual assessment for this purpose, which for fiscal 2005 and 2004 was equal to 0.0444% and 0.0154%, respectively, of its insured deposits and which is recorded as a deposit insurance premium expense for financial statement purposes. Beginning in 2006, the assessment was revised to 0.0132% of the Bank's insured deposits.

Reserve Requirements. The Bank must maintain non-interest-earning reserves against its transaction accounts (primarily NOW and regular checking accounts). The Bank is generally able to satisfy reserve requirements with cash on hand and other non-interest bearing deposits which it maintains for other purposes, so the reserve requirements do not impose a material financial burden on the Bank.

Governmental Policies. Our earnings are significantly affected by the monetary and fiscal policies of governmental authorities, including the Federal Reserve. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open-market operations in U.S. Government securities and Federal funds, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These instruments of monetary policy are used in varying combinations to influence the overall level of bank loans, investments and deposits, and the interest rates charged on loans and paid for deposits. The Federal Reserve frequently uses these instruments of monetary policy, especially its open-market operations and the discount rate, to influence the level of interest rates and to affect the strength of the economy, the level of inflation or the price of the dollar in foreign exchange markets. The monetary policies of the Federal Reserve have had a significant effect on the operating results of banking institutions in the past and are expected to continue to do so in the future. It is not possible to predict the nature of future changes in monetary and fiscal policies, or the effect which they may have on our business and earnings.

Personal Holding Company Status. For the fiscal years ended December 31, 2005, 2004 and 2003, the Company has been deemed to be a Personal Holding Company (a "PHC"), as defined in the Internal Revenue Code. As a PHC, we may be required to pay an additional income tax or issue a dividend to our shareholders in an amount based upon the PHC Internal Revenue Code formulas, which is primarily based upon net income. No such dividend was required to be paid in fiscal 2005, 2004 and 2003. (See Dividends in Item 5).

Employees. On February 20, 2006, Berkshire had one full time employee and the Bank employed approximately 100 full time and 6 part time employees. The Bank's employees are not represented by a collective bargaining unit, and the Bank considers its relationship with its employees to be good.

ITEM 1A. Risk Factors.

Our business faces significant risks. These risks include those described below and may include additional risks and uncertainties not presently known to us or that we currently deem immaterial. Our business, financial condition and results of operations could be materially adversely affected by any of these risks, and the trading price of our common stock could decline.

We operate in the highly competitive banking industry and there can be no assurance that we will be able to compete successfully.

Our ability to maintain our history of strong financial performance and return on investment to shareholders may depend in part on our ability to expand our scope of available financial services as needed to meet the needs and demands of our customers. Our business model focuses on using superior customer service to provide traditional banking services to a growing customer base. However, we operate in an increasingly competitive environment in which our competitors now include securities dealers, brokers, mortgage bankers, investment advisors and finance and insurance companies who seek to offer one-stop financial services to their customers that may include services that we have not been able or allowed to offer to our customers in the past. This increasingly competitive environment is primarily a result of changes in regulation, changes in technology and product delivery systems and the accelerating pace of consolidation among financial services providers. We cannot assure you that we will be able to continue to compete successfully in this environment without expanding the scope of financial services we provide, or that if we need to expand the scope of services that we provide, that we will be able to do so successfully.

Our future success depends on our ability to compete effectively in a highly competitive market and geographic area.

We face substantial competition in all phases of our operations from a variety of different competitors. We encounter competition from other commercial banks, savings and loan associations, mutual savings banks, credit unions and other financial institutions. Our competitors, including credit unions, consumer finance companies, factors, insurance companies and money market mutual funds, compete with lending and deposit-gathering services offered by us. There is very strong competition for financial services in the New York state areas in which we currently conduct our business. This geographic area includes offices of many of the largest financial institutions in the world. Many of those competing institutions have much greater financial and marketing resources than we have. Due to their size, many competitors can achieve larger economies of scale and as a result may offer a broader range of products and services than we do. If we are unable to offer competitive products and services, our earnings may be negatively affected. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies like ourselves and on federally insured financial institutions like our banking subsidiary, The Berkshire Bank. As a result, these nonbank competitors have certain advantages over us in accessing funding and in providing various services. The banking business in our current primary market area is very competitive, and the level of competition we face may increase further, which may limit our asset growth and profitability.

Economic conditions either nationally or locally in areas in which our operations are concentrated may be less favorable than expected.

Deterioration in local, regional, national or global economic conditions could result in, among other things, an increase in loan delinquencies, a decrease in property values, a change in housing turnover rate or a reduction in the level of bank deposits. Particularly, a weakening of the real estate or employment market in our primary market areas could result in an increase in the number of borrowers who default on their loans and a reduction in the value of the collateral securing their loans, which in turn could have an adverse effect on our profitability. Substantially all of our real estate loans are collateralized by properties located in these market areas, and substantially all of our loans are made to borrowers who live in and conduct business in these market areas. Any material economic deterioration in these market areas could have an adverse impact on our profitability.

Changes in interest rates could reduce our income and cash flows.

Our income and cash flow and the value of our assets and liabilities depend to a great extent on the difference between the interest rates earned on interest-earning assets such as loans and investment securities, and the interest rates paid on interest-bearing liabilities such as deposits and borrowings. These rates are highly sensitive to many factors which are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies, in particular, the Board of Governors of the Federal Reserve

System. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the returns on our portfolio of investment securities and the amounts paid on deposits. If the rate of interest we pay on deposits and other borrowings increases more than the rate of interest we earn on loans and other investments, our net interest income, and therefore our earnings, could be adversely affected. Our earnings could also be adversely affected if the rates on our loans and other investments fall more quickly than those on our deposits and other borrowings.

We operate in a highly regulated environment; changes in laws and regulations and accounting principles may adversely affect us.

We are subject to extensive state and federal regulation, supervision, and legislation which govern almost all aspects of our operations. These laws may change from time to time and are primarily intended for the protection of customers, depositors, and the deposit insurance funds. The impact of any changes to these laws may negatively impact our ability to expand our services and to increase the value of our business. Regulatory authorities have extensive discretion in the exercise of their supervisory and enforcement powers. They may, among other things, impose restrictions on the operation of a banking institution, the classification of assets by such institution and such institution's allowance for loan losses. Regulatory and law enforcement authorities also have wide discretion and extensive enforcement powers under various consumer protection, civil rights and other laws, including the Gramm-Leach-Blilely Act, the Bank Secrecy Act, the Truth-in-Lending Act, the Equal Credit Opportunity Act, the Fair Housing Act and the Real Estate Settlement Procedures Act. These laws also permit private individual and class action lawsuits and provide for the recovery of attorneys fees in certain instances. Any changes to these laws or any applicable accounting principles may negatively impact our results of operations and financial condition. While we cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have, these changes could be materially adverse to our investors and stockholders.

We are required to maintain an allowance for loan losses. These reserves are based on management's judgment and may have to be adjusted in the future. Any adjustment to the allowance for loan losses, whether due to regulatory changes, economic conditions or other factors, may affect our financial condition and earnings.

We maintain an allowance for loan losses. The allowance for loan losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio. In conjunction with an internal loan review function that operates independently of the lending function, management monitors the loan portfolio to identify risks on a timely basis so that an appropriate allowance can be maintained. Based on an evaluation of the loan portfolio, management presents a periodic review of the loan loss reserve to the board of directors of the Bank, indicating any changes in the reserve since the last review and any recommendations as to adjustments in the reserve. In making its evaluation, in addition to the factors discussed below, management considers the results of recent regulatory examinations, which typically include a review of the allowance for loan losses as an integral part of the examination process.

In establishing the allowance, management evaluates individual large classified loans and nonaccrual loans, and determines an aggregate reserve for those loans based on that review. An allowance for the remainder of the loan portfolio is also determined based on historical loss experience within the components of the portfolio. These allocations may be modified if current conditions indicate that loan losses may differ from historical experience, based on economic factors and changes in portfolio mix and volume.

In addition, a portion of the allowance is established for losses inherent in the loan portfolio which have not been identified by the more quantitative processes described above. This determination inherently involves a higher degree of subjectivity, and considers risk factors that may not have yet manifested themselves in historical loss experience. Those factors include changes in levels and trends of charge-offs, delinquencies, and nonaccrual loans, trends in volume and terms of loans, changes in underwriting standards and practices, portfolio mix, tenure of loan officers and management, entrance into new geographic markets, changes in credit concentrations, and national and local economic trends

and conditions. While the allowance for loan losses is maintained at a level believed to be adequate by management for estimated losses in the loan portfolio, determination of the allowance is inherently subjective, as it requires estimates, all of which may be susceptible to significant change. Changes in these estimates may impact the provisions charged to expense in future periods. Federal and state regulatory authorities, as an integral part of their examination process, review our loans and allowance for loan losses. We cannot assure you that we will not increase the allowance for loan losses or the regulators will not require us to increase this allowance. Either of these occurrences could negatively impact Berkshire Bancorp's results of operations.

It may be difficult for a third party to acquire us and this could depress our common stock price.

Under our amended and restated certificate of incorporation, we have authorized 2,000,000 shares of preferred stock, which the board of directors may issue with terms, rights, preferences and designations as the board of directors may determine and without any vote of the shareholders, unless otherwise required by law. Issuing the preferred stock, depending upon the rights, preferences and designations set by the board of directors, may delay, deter, or prevent a change in control of the Company.

In addition, we have authorized 10,000,000 shares of common stock of which approximately 7.7 million shares have been issued and approximately 6.9 million shares are outstanding. The price of our common stock may be volatile at times since our common stock is thinly traded and one individual owns or controls approximately 50% of our outstanding shares. It may be difficult for a stockholder to sell a significant number of shares at a time and at a price of their choosing or for a third party to purchase sufficient shares on the open market to cause a change in control of the Company, all of which could depress the price of Berkshire Bancorp's common stock.

In addition, federal and state banking laws may restrict the ability of the stockholders to approve a merger or business combination or obtain control of the Company. This may tend to make it more difficult for shareholders to replace existing management or may prevent shareholders from receiving a premium for their shares of our common stock.

Our common stock is not insured by any governmental agency and, therefore, investment in them involves risk.

Our securities are not deposit accounts or other obligation of any bank, and are not insured by the FDIC, or any other governmental agency, and are subject to investment risk, including the possible loss of principal.

ITEM 1B. Unresolved Staff Comments.

Not Applicable

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ITEM 2. Properties.

The following are Berkshire's and the Bank's principal facilities as of February 20, 2006:

Location	Operations	Approximate Floor Area (Sq. Ft.)	Approximate Annual Rent	Lease Expiratio
New York, NY	Executive Offices	1,500	$ 18,000	(1)(3)
New York, NY	Main Bank Office and Bank Branch	9,700	Owned	Feb 2008
Brooklyn, NY	Bank Branch	4,500	$ 200,418	March 20
Brooklyn, NY	Bank Branch	2,866	$ 59,130	March 20
Brooklyn, NY	Bank Branch	2,592	$ 108,212	December
Brooklyn, NY	Bank Branch	1,640	$ 72,000	June 201
New York, NY	Bank Branch	9,924	$ 353,315	June 201
Goshen, NY	Bank Branch	10,680	Owned	
Harriman, NY	Bank Branch	1,623	Owned	
Bloomingburg, NY	Bank Branch	1,530	$ 20,871	August 2
Ridgefield, NJ	Bank Branch		Owned	

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(1) Rented on a month to month basis from a company affiliated with Mr. Moses Marx, a director of the Company.

(2) Leased from a company affiliated with Mr. Marx, a director of the Company. (3) Management believes the annual rent paid is comparable to the annual rent that would be paid to non-affiliated parties in a similar commercial transaction for similar commercial space.

ITEM 3. Legal Proceedings.

In the ordinary course of operations, the Bank is a party to routine litigation involving claims incidental to its banking business. Management believes that no current litigation, threatened or pending, to which we or our assets are a party, poses a substantial likelihood of potential loss or exposure which would have a material adverse effect on the financial condition or results of our operations.

ITEM 4. Submission of Matters to a Vote of Security Holders.

Not Applicable.

PART II

ITEM 5. Market for Registrant's Common Equity, Issuer Purchases of Equity Securities and Related Stockholder Matters.

The Company's Common Stock trades on the Nasdaq National Market System under the symbol BERK. The following table sets forth, for the periods indicated, the high and low sales prices for the Company's Common Stock, restated to reflect the reverse split and stock dividend which occurred on May 18, 2004, as reported by NASDAQ.

Fiscal Year Ended December 31, 2005	High	Low
January 1, 2005 to March 31, 2005	22.04	19.51
April 1, 2005 to June 30, 2005	20.98	17.50
July 1, 2005 to September 30, 2005	18.75	17.02
October 1, 2005 to December 31, 2005	18.30	15.83

Fiscal Year Ended December 31, 2004	High	Low
January 1, 2004 to March 31, 2004	19.67	16.33
April 1, 2004 to June 30, 2004	19.33	15.00
July 1, 2004 to September 30, 2004	17.40	15.02
October 1, 2004 to December 31, 2004	20.50	16.10

As of the close of business on February 20, 2006, there were approximately 1,490 holders of record of the Company's Common Stock.

Dividends

For the fiscal years ended December 31, 2005, 2004 and 2003, the Company has been deemed to be a PHC, as defined in the Internal Revenue Code. As a PHC, we may be required to pay an additional income tax or issue a dividend to our shareholders in an amount based upon applicable Internal Revenue Code formulas, which is primarily based upon net income. No such dividend was required to be paid in fiscal 2005, 2004 and 2003.

On March 23, 1999, the Board of Directors adopted a policy of paying regular cash dividends in respect of the Common Stock of the Company, payable in equal semi-annual installments. Pursuant to said policy, the Board of Directors declared and the Company paid cash dividends, restated to reflect the reverse split and stock dividend which occurred on May 18, 2004, as follows:

Declaration Date	Record Date	Payment Date	Per Share Amount
April 8, 2003	April 23, 2003	April 30, 2003	$
October 3, 2003	October 21, 2003	October 29, 2003	$
April 1, 2004	April 19, 2004	April 28, 2004	$
October 5, 2004	October 22, 2004	October 29, 2004	$
March 21, 2005	April 22, 2005	April 29, 2005	$
October 7, 2005	October 21, 2005	October 28, 2005	$

The declaration, payment and amount of such dividends in the future are within the discretion of the Board of Directors and will depend upon our earnings, capital requirements, financial condition and other relevant factors.

Equity Compensation Plans

See Part III, Item 12 for information concerning the Company's equity compensation plans.

ITEM 6. Selected Financial Data.

BERKSHIRE BANCORP INC. AND SUBSIDIARIES

Five Year Financial Highlights (a)(b)

The following is a summary of certain financial information with respect to the Company at and for the fiscal years ended December 31, 2005, 2004, 2003, 2002 and 2001. This information is derived from and should be read in conjunction with the Company's financial statements and notes thereto included elsewhere in this Form 10-K.

	December 31,			
	2005	2004	2003	2002
	(Dollars in thousands,except per share			
Balance Sheet Data:				
Total Assets	$977,452	$972,649	$905,669	$683,738
Loans, net	305,964	284,052	292,163	273,182
Investment securities	599,972	631,592	569,848	371,458
Goodwill, net	18,549	18,549	18,549	18,549
Deposits	680,260	619,888	604,255	473,818
Borrowings	156,245	223,352	192,136	104,372
Subordinated debt	22,681	15,464	--	--
Stockholders' equity	108,710	107,619	103,490	98,525
Statement of Operations Data:				
Interest income	45,056	40,008	34,426	32,242
Interest expense	22,399	15,916	13,647	13,416
Net interest income before provision for loan losses	22,657	24,092	20,779	18,826
Provision for loan losses	180	180	240	387
Net interest income	22,477	23,912	20,539	18,439
Investment securities gains	4	793	2,746	1,539
Other income	1,202	1,026	1,237	748
Other expenses	13,139	12,095	11,463	10,780
Amortization of goodwill	--	--	--	--
Income before income taxes	10,544	13,636	13,059	9,946
Provision for income taxes	5,003	6,134	5,644	4,349
Net income	$ 5,541	$ 7,502	$ 7,415	$ 5,597
Net income per share:				
Basic	$ .81	$ 1.12	$ 1.12	$ .81
Diluted	$ .80	$ 1.10	$ 1.10	$ .81
Cash dividends per common share	$ .15	$ .11	$ .09	$ .07
Selected Operating Ratios				
Return on average assets	0.6%	0.8%	0.9%	0.9%
Return on average equity	5.1%	7.2%	7.2%	5.9%
Net interest margin	2.4%	2.6%	2.7%	3.3%
Average equity/average assets	11.1%	11.0%	12.7%	15.6%
Allowance for loan losses/total loans	1.1%	1.0%	0.9%	0.8%

(a) The prior years' amounts have been reclassified to conform to the current years' presentation.

(b) The prior years' net income per share and cash dividends per common share amounts have been retroactively restated to reflect the one-for-ten reverse stock split and thirty-for-one forward stock split which occurred on May 18, 2004.

ITEM 7. Managements' Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of Berkshire Bancorp Inc. and subsidiaries for the fiscal years ended December 31, 2005, 2004 and 2003. All references to earnings per share, unless stated otherwise, refer to earnings per diluted share. References to per share amounts for the fiscal year ended December 31, 2003 have been revised to reflect the reverse stock split and stock dividend which occurred on May 18, 2004. The discussion should be read in conjunction with the consolidated financial statements and related notes (Notes located in Item 8 herein). Reference is also made to Part I, Item 1 "Business" herein.

Segments

Management has determined that the Company through its wholly owned bank subsidiary, the Bank, operates in one business segment, community banking. The Bank's principal business activity consists of gathering deposits from the general public and investing those deposits in residential and commercial mortgage loans and commercial non-mortgage loans, both unsecured and secured by personal property. In addition, the Bank invests those deposits in debt obligations issued by the U.S. Government, its agencies, business corporations and mortgage-backed securities.

General

Stock Split and Stock Dividend. At the Annual Meeting of Stockholders held on May 18, 2004, the Company's stockholders approved the Reverse Split. Following the effectiveness of the Reverse Split, the Company's Board of Directors declared a stock dividend which became effective immediately. The Company paid approximately $463,000 to purchase fractional shares from stockholders as part of the Reverse Split. The Company's Common Stock began trading on May 19, 2004 giving effect to these transactions.

Trust Preferred Securities. As of May 18 2004, the Company established BCTI. The Company owns all the common capital securities of BCTI. BCTI issued $15.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTI's common capital securities, in the Company through the purchase of $15.464 million aggregate principal amount of the Floating Rate Junior Subordinated Debentures issued by the Company. The Debentures, the sole assets of BCTI, mature on July 23, 2034 and bear interest at a floating rate, three month LIBOR plus 2.70%.

On April 1, 2005, the Company established BCTII. The Company owns all the common capital securities of BCTII. BCTII issued $7.0 million of preferred capital securities to investors in a private transaction and invested the proceeds, combined with the proceeds from the sale of BCTII's common capital securities, in the Company through the purchase of $7.217 million aggregate principal amount of the 2005 Debentures issued by the Company. The 2005 Debentures, the sole assets of BCTII, mature on May 23, 2035 and bear interest at a floating rate, three month LIBOR plus 1.95%. See Note A of Notes to Consolidated Financial Statements for a further discussion of Trust Preferred Securities.

Branch Purchase

In September 2005, the Bank entered into an Agreement with Oritani, a New Jersey Chartered Savings Bank. Pursuant to the Agreement, the Bank will (i) assume certain commercial checking account deposit liabilities and (ii) purchase certain fixed assets and the real property of this Oritani bank branch located in Ridgefield, New Jersey for a cash purchase price of $850,000. Upon the closing of the transaction, which is subject to the approval of regulatory authorities, among other things, the Bank intends to open a branch of The Berkshire Bank at the Ridgefield, New Jersey location.

New Subsidiary

In August 2005, the Bank formed Berkshire 1031, a wholly owned limited liability company. Berkshire 1031 will act as a qualified intermediary in connection with tax free exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended. A qualified intermediary is an individual or business entity that assists owners of property who wish to exchange their property for property of a "like-kind" in a transaction that is tax free in whole or part for federal (and in some cases state) income tax purposes. In accordance with detailed procedures set forth in federal income tax regulations, Berkshire 1031 will assist the owner in the sale of the owner's property and the purchase of replacement property so that the transaction qualifies as a non-taxable exchange of property.

Critical Accounting Policies, Judgments and Estimates

The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and general practices within the financial services industry. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and the assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

The Company considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than any of its other significant accounting policies. The allowance for loan losses is calculated with the objective of maintaining a reserve level believed by management to be sufficient to absorb estimated credit losses. Management's determination of the adequacy of the allowance is based on periodic evaluations of the loan portfolio and other relevant factors. However, this evaluation is inherently subjective as it requires material estimates, including, among others, expected default probabilities, loss given default, the amounts and timing of expected future cash flows on impaired loans, mortgages, and general amounts for historical loss experience. The process also considers economic conditions, uncertainties in estimating losses and inherent risks in the loan portfolio. All of these factors may be susceptible to significant change. To the extent actual outcomes differ from management estimates, additional provisions for loan losses may be required that would adversely impact earnings in future periods.

With the adoption of Statement of Financial Accounting Standards ("SFAS") No. 142 ("SFAS No. 142") on January 1, 2002, the Company discontinued the amortization of goodwill resulting from acquisitions. Goodwill is now subject to impairment testing at least annually to determine whether write-downs of the recorded balances are necessary. The Company tests for impairment based on the goodwill maintained at the Bank. A fair value is determined for each reporting unit based on at least one of three various market valuation methodologies. If the fair values of the reporting units exceed their book values, no write-down of recorded goodwill is necessary. If the fair value of the reporting unit is less, an expense may be required on the Company's books to write down the related goodwill to the proper carrying value. As of December 31, 2005, the Company completed its annual impairment testing, which determined that no impairment write-offs were necessary.

The Company recognizes deferred tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryforwards and tax credits. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. If management determines that the Company may be unable to realize all or part of net deferred tax assets in the future, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount.

Discussion of Financial Condition and Results of Operations

Overview

Fiscal Year Ended December 31, 2005 Compared to Fiscal Year Ended December 31, 2004. Net income was $5.54 million, or $.80 per diluted share, for the fiscal year ended December 31, 2005, compared to $7.50 million, or $1.10 per diluted share, for the fiscal year ended December 31, 2004. Net loans and total assets increased by approximately 8% and 1%, respectively, and investment securities decreased by approximately 5%.

	Fiscal Year Ended December 31,		
	2005	2004	% Inc/(Dec)
	(In millions, except per share data)		
Total Assets	$ 977.7	$ 972.6	1%
Loans, net	305.9	284.1	8%
Investment Securities	600.0	631.6	(5)%
Total Liabilities	868.7	865.0	0%

Deposits	680.3	619.9	10%
Borrowings	178.9	238.8	(25)%
Stockholders' Equity	109.0	107.6	1%
Total Income	46.3	41.8	11%
Interest Income	45.1	40.0	13%
Total Expense	35.5	28.0	27%
Interest Expense	22.4	15.9	41%
Net Interest Income	22.7	24.1	(6)%
Net Income	5.5	7.5	(27)%
Diluted Income Per Share	.80	1.10	(27)%
Bank Branches	10	9	--

Fiscal Year Ended December 31, 2004 Compared to Fiscal Year Ended December 31, 2003. Net income was $7.50 million, or $1.10 per diluted share, for the fiscal year ended December 31, 2004, compared to $7.42 million, or $1.10 per diluted share, for the fiscal year ended December 31, 2003. Investment securities and total assets increased by approximately 11% and 7%, respectively, and net loans decreased by approximately 3%.

	Fiscal Year Ended December 31,		
	2004	2003	% Inc/(Dec)
	(In millions, except per share data)		
Total Assets	$ 972.6	$ 905.7	7%
Loans, net	284.1	292.2	(3)%
Investment Securities	631.6	569.8	11%
Total Liabilities	865.0	802.2	8%
Deposits	619.9	604.3	3%
Borrowings	238.8	192.1	24%
Stockholders' Equity	107.6	103.5	4%
Total Income	41.8	38.4	9%
Interest Income	40.0	34.4	16%
Total Expense	28.0	25.4	10%
Interest Expense	15.9	13.6	17%
Net Interest Income	24.1	20.8	16%
Net Income	7.5	7.4	1%
Diluted Income Per Share	1.10	1.10	0%
Bank Branches	9	9	--

Net Interest Income

Net interest income, represents the difference between total interest income earned on earning assets and total interest expense paid on interest-bearing liabilities. The amount of interest income is dependent upon many factors including: (i) the amount of interest-earning assets that the Company can maintain based upon its funding sources; (ii) the relative amounts of interest- earning assets versus interest-bearing liabilities; and (iii) the difference between the yields earned on those assets and the rates paid on those liabilities. Non-performing loans adversely affect net interest income because they must still be funded by interest-bearing liabilities, but they do not provide interest income. Furthermore, when we designate an asset as non-performing, all interest which has been accrued but not actually received is deducted from current period income, further reducing net interest income.

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The Company's average balances, interest, and average yields are set forth on the following table (in thousands, except percentages):

	Twelve Months Ended December 31, 2005			
	Average Balance	Interest and Dividends	Average Yield/Rate	Average Balance
INTEREST-EARNING ASSETS:				
Loans (1)	$ 287,178	$ 19,399	6.76%	$ 290,774
Investment securities	648,829	25,355	3.91	620,511
Other (2)(5)	10,765	302	2.81	4,376
Total interest-earning assets	946,772	45,056	4.76	915,661
Noninterest-earning assets	44,497			40,592
Total Assets	$ 991,269			$ 956,253
INTEREST-BEARING LIABILITIES:				
Interest bearing deposits	264,130	4,639	1.76	272,219
Time deposits	338,834	9,552	2.82	309,968
Other borrowings	225,657	8,208	3.64	223,208
Total interest-bearing liabilities	828,621	22,399	2.70	805,395
Demand deposits	44,739			38,896
Noninterest-bearing liabilities	8,310			7,163
Stockholders' equity (5)	109,599			104,799
Total liabilities and stockholders' equity	$ 991,269			$ 956,253
Net interest income		$ 22,657		
Interest-rate spread (3)			2.06%	

			====	
Net interest margin (4)			2.39%	
			====	
Ratio of average interest-earning assets to average interest bearing liabilities	1.14			1.14
	=========			=========

	Twelve Months Ended December 31, 2003		
	Average Balance	Interest and Dividends	Average Yield/Rate
INTEREST-EARNING ASSETS:			
Loans (1)	$ 291,586	$ 19,061	6.54%
Investment securities	470,412	15,321	3.26
Other (2)(5)	3,946	44	1.12
	---------	--------	----
Total interest-earning assets	765,944	34,426	4.49

Noninterest-earning assets	37,844		

Total Assets	$ 803,788		
	=========		
INTEREST-BEARING LIABILITIES:			
Interest bearing deposits	201,817	2,593	1.28
Time deposits	333,112	7,537	2.26
Other borrowings	125,609	3,517	2.80
	---------	--------	----
Total interest-bearing liabilities	660,538	13,647	2.07
		--------	----
Demand deposits	32,592		
Noninterest-bearing liabilities	8,318		
Stockholders' equity (5)	102,340		

Total liabilities and stockholders' equity	$ 803,788		
	=========		
Net interest income		$ 20,779	
		========	
Interest-rate spread (3)			2.42%
			====
Net interest margin (4)			3.71%
			====
Ratio of average interest-earning assets to average interest bearing liabilities	1.16		

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(1) Includes nonaccrual loans.
(2) Includes interest-bearing deposits, federal funds sold and securities purchased under agreements to resell.
(3) Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest bearing liabilities.
(4) Net interest margin is net interest income as a percentage of average interest-earning assets.
(5) Average balances for Berkshire Bancorp Inc. (parent only) have been calculated on a monthly basis.

Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following tables set forth certain information regarding changes in interest income and interest expense of the Company for the years indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in rate (change in rate multiplied by prior volume), (2) changes in volume (changes in volume multiplied by prior rate) and (3) changes in rate-volume (change in rate multiplied by change in volume) (in thousands):

	Twelve Months Ended December 31, 2005 Versus Twelve Months Ended December 31, 2004 Increase (Decrease) Due To		
	Rate	Volume	Total
Interest-earning assets:			
Loans	$ 843	$ (269)	$
Investment securities	3,165	1,070	4,
Other	60	179	
Total	4,068	980	5,
Interest-bearing liabilities:			
Deposit accounts:			
Interest bearing deposits	1,007	(177)	
Time deposits	2,728	800	3,
Other borrowings	2,031	94	2,
Total	5,766	717	6,

Net interest income	$(1,698)	$ 263	$(1,

	Twelve Months Ended December 31, 2004 Versus Twelve Months Ended December 31, 2003 Increase (Decrease) Due To		
	Rate	Volume	Total
Interest-earning assets:			
Loans	$ (204)	$ (32)	$ (
Investment securities	659	5,140	5,
Other	13	6	
Total	468	5,114	5,
Interest-bearing liabilities:			
Deposit accounts:			
Interest bearing deposits	222	994	1,
Time deposits	(1,066)	(447)	(1,
Other borrowings	(88)	2,654	2,
Total	(932)	3,201	2,
Net interest income	$ 1,400	$ 1,913	$ 3,

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Interest Rate Risk

Fluctuations in market interest rates can have a material effect on the Company's net interest income because the yields earned on loans and investments may not adjust to market rates of interest with the same frequency, or with the same speed, as the rates paid by the Bank on its deposits.

Most of the Bank's deposits are either interest-bearing demand deposits or short term certificates of deposit and other interest-bearing deposits with interest rates that fluctuate as market rates change. Management of the Bank seeks to reduce the risk of interest rate fluctuations by concentrating on loans and securities investments with either short terms to maturity or with adjustable rates or other features that cause yields to adjust based upon interest rate fluctuations. In addition, to cushion itself against the potential adverse effects of a substantial and sustained increase in market interest rates, the Bank has purchased off balance sheet interest rate cap contracts which generally provide that the Bank will be entitled to receive payments from the other party to the contract if interest rates exceed specified levels. These contracts are entered into with major financial institutions.

We seek to maximize our net interest margin within an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of the forecasted net interest income that may be gained or lost due to favorable or unfavorable movements in interest rates. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities.

Allowance for Loan Losses

The Company maintains an allowance for loan losses at a level deemed sufficient to absorb losses, which are inherent in the loan portfolio at each balance sheet date. Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management's assessment of estimated losses. The Company's methodology for assessing the appropriateness of the allowance for loan losses consists of several key elements. These elements include a specific allowance for loan watch list classified loans, an allowance based on historical trends, an additional allowance for special circumstances, and an unallocated portion. The Company consistently applies the following comprehensive methodology.

The allowance for loan watch list classified loans addresses those loans maintained on the Company's loan watch list which are assigned a rating of substandard, doubtful, or loss. Substandard loans are those with a well-defined weakness or a weakness, which jeopardizes the repayment of the debt. A loan may be classified as substandard as a result of impairment of the borrower's financial condition and repayment capacity. Loans for which repayment plans have not been met or collateral equity margins do not protect the Company may also be classified as substandard. Doubtful loans have the characteristics of substandard loans with the added characteristic that collection or liquidation in full, on the basis of presently existing facts and conditions, is highly improbable. Although the possibility of loss is extremely high for doubtful loans, the classification of loss is deferred until pending factors, which might improve the loan, have been determined. Loans rated as doubtful in whole or in part are placed in nonaccrual status. Loans which are classified as loss are considered uncollectible and are charged to the allowance for loan losses. There were $330,000, $343,000 and $109,000 of classified loans at December 31, 2005, 2004 and 2003, respectively.

Loans on the loan watch list may also be impaired loans, which are defined as nonaccrual loans or troubled debt restructurings, which are not in compliance with their restructured terms. Each of the classified loans on the loan watch list is individually analyzed to determine the level of the potential loss in the loan under the current circumstances. The specific reserve established for these criticized and impaired loans is based on careful analysis of the loan's performance, the related collateral value, cash flow considerations and the financial capability of any guarantor. The allowance for loan watch list classified loans is equal to the total amount of potential unconfirmed losses for the individual classified loans on the watch list. Loan watch list loans are managed and monitored by assigned Senior Management.

The allowance based on historical trends uses charge-off experience of the Company to estimate potential unconfirmed losses in the balances of the loan and lease portfolios. The historical loss experience percentage is based on the charge-off history. Historical loss experience percentages are applied to all non-classified loans to obtain the portion of the allowance for loan losses which is based on historical trends. Before applying the historical loss experience percentages, loan balances are reduced by the portion of the loan balances which are subject to guarantee by a government agency. Loan balances are also adjusted for unearned discount on installment loans.

The Company also maintains an unallocated allowance. The unallocated allowance is used to cover any factors or conditions which may cause a potential loan loss but are not specifically identifiable. It is prudent to maintain an unallocated portion of the allowance because no matter how detailed an analysis of potential loan losses is performed these estimates by definition lack precision. Management must make estimates using assumptions and information, which is often subjective and changing rapidly.

Since all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

A loan is placed in a nonaccrual status at the time when ultimate collectibility of principal or interest, wholly or partially, is in doubt. Past due loans are those loans which were contractually past due 90 days or more as to interest or principal payments but are well secured and in the process of collection. Renegotiated loans are those loans which terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of the deteriorating financial position of the borrower.

Results of Operations Fiscal Year Ended December 31, 2005 Compared to Fiscal Year Ended December 31, 2004.

General. References to per share amounts below, unless stated otherwise, refer to diluted shares.

Net Income. Net income for the fiscal year ended December 31, 2005 was $5.54 million, or $.80 per share, as compared to $7.50 million, or $1.10 per share, for the fiscal year ended December 31, 2004.

The Company's net income is largely dependent on interest rate levels, the demand for the Company's loan and deposit products and the strategies employed to manage the interest rate and other risks inherent in the banking business. From June 2003 through June 30, 2004, interest rates, as measured by the prime rate, remained constant at 4.00%. On July 1, 2004, inflation fighting actions taken by the Federal Reserve Board with respect to short-term interest rates (the only rates it can control) resulted in a 25 basis point increase in the prime rate to 4.25%, the first such increase in short-term rates in more than four years. Similar 25 basis point moves in the federal funds rate taken by the Federal Reserve Board during 2004 and 2005, the most recent occurring on January 31, 2006, have moved the prime rate to its present level of 7.50%, the longest sustained period of monetary policy tightening in more than a decade.

While short-term market rates have followed the upticks of federal funds, long-term interest rates have declined during this period, a condition referred to as a flattening yield curve. A flat or narrowing yield curve places a squeeze on interest margins for financial institutions, like the Company, who depend upon a spread between long- and short-term rates for interest margin profits and the largest percentage of income.

Net Interest Income. The Company's primary source of revenue is net interest income, or the difference between interest income on earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities such as deposits and borrowings.

For the fiscal year ended December 31, 2005, net interest income decreased by $1.44 million, or 5.96%, to $22.66 million from $24.09 million for the fiscal year ended December 31, 2004. The decrease in net interest income was the result of the 28.84% growth in the average amount of interest-bearing liabilities to $828.62 million during fiscal 2005 from $805.40 million in fiscal 2004 and the 72 basis point increase in the average rates paid on such liabilities to 2.70% in 2005 from 1.98% in 2004. The decrease in net interest income was partially offset by the 3.40% increase in the average amount of interest-earning assets to $946.77 million during 2005 from $915.66 million in 2004 and the 39 basis point increase in the average yields earned on such earning assets to 4.76% in 2005 from 4.37% in 2004.

Also contributing to the change in net interest income was the interest- rate spread or the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities. During fiscal 2005, the Company's interest-rate spread decreased by 33 basis points to 2.06% from 2.39% during fiscal 2004. If interest rates remain at current levels or increase slowly over time, we expect to see only moderate pressure on the Company's interest-rate spread and net interest income. Investment securities in our portfolio that have been sold, matured or called by the issuer during fiscal 2004 and 2005 have been replaced with securities carrying somewhat higher yields and, by design, shorter maturities to provide a hedge against a rising interest rate environment. Rates paid on deposit accounts are likely to increase in a rising rate environment due to competition for deposits in the market place. The cost of borrowed funds with floating rather than fixed interest rates will increase as well.

Net Interest Margin. Net interest margin, or annualized net interest income as a percentage of average interest-earning assets, declined to 2.39% in fiscal 2005 from 2.63% in fiscal 2004. We seek to secure and retain customer deposits with competitive products and rates, while making strategic use of the prevailing interest rate environment to borrow funds at what we believe to be attractive rates. We invest such deposits and borrowed funds in a prudent mix of fixed rate and adjustable rate loans, investment securities and short-term interest-earning assets which provided an aggregate average yield of 4.76% and 4.37% in fiscal 2005 and 2004, respectively.

The average amount of loans decreased slightly to $287.18 million in fiscal 2005 from $290.77 million in fiscal 2004, however, the average yield on the loan portfolio increased by 29 basis points to 6.76% in fiscal 2005 from 6.47% in fiscal 2004. During periods of low and stable interest rates borrowers gravitate towards fixed-rate loans to lock in a low interest rate. Adjustable rate loans are generally preferred when interest rates are trending higher as they did in 2004 and 2005. One-to-four family mortgage loans, approximately 45% and 54% of our loan portfolio at December 31, 2005 and 2004, respectively, are particularly sensitive to changes in interest rates.

The average amount of investment securities increased by $28.32 million to $648.83 million in fiscal 2005 from $620.51 million in fiscal 2004. The average yield on investment securities improved by 51 basis points, to 3.91% in 2005 from 3.40% in 2004 and are likely to continue to increase in a rising interest rate environment. The average amount of other interest-earning assets, primarily short-term investments, increased by $6.39 million to $10.77 million in 2005 from $4.38 million in 2004 and returned an average yield of 2.81% and 1.44% in fiscal 2005 and 2004, respectively.

Interest Income. Total interest income for the fiscal year ended December 31, 2005 increased by $5.05 million, or 12.62%, to $45.06 million from $40.01 million for the fiscal year ended December 31, 2004. The increase in interest income was primarily due to the growth in the average amount of total interest-earning assets. Loans contributed $19.40 million of interest income in fiscal 2005, an increase of $574,000 from the $18.83 million of interest income contributed in fiscal 2004. Investment securities contributed $25.36 million of interest income in fiscal 2005, an increase of $4.24 million over the $21.12 million of interest income earned on loans in fiscal 2004.

	Fiscal 2005		Fiscal 2004	
	Interest Income	% of Total	Interest Income	% of Total
	(In thousands, except percentages)			
Loans	$19,399	43.06%	$18,825	47.05%
Investment Securities	25,355	56.27	21,120	52.79
Other	302	0.67	63	0.16
Total Interest Income	$45,056	100.00%	$40,008	100.00%

Loans, which are inherently risky and therefore command a higher return than our conservative portfolio of investment securities, declined to 30.33% of our total average interest-earning assets in fiscal 2005 from 31.76% in fiscal 2004. While we actively seek to originate new loans with qualified borrowers who meet the Bank's underwriting standards, our strategy has been to maintain those standards, sacrificing some current income to avoid possible large future losses in the loan portfolio.

	Fiscal 2005		Fiscal 2
	Average Amount	% of Total	Average Amount
	(In thousands, except percentages)		
Loans	$287,178	30.33%	$290,774
Investment Securities	648,829	68.53	620,511
Other	10,765	1.14	4,376

Total Interest-Earning Assets	$946,772	100.00%	$915,661

Interest Expense. Total interest expense for the fiscal year ended December 31, 2005 increased by $6.48 million, or 40.73%, to $22.40 million from $15.92 million for the fiscal year ended December 31, 2004. The increase in interest expense was due to the growth in the average amount of interest-bearing liabilities and the increase in the average rate paid on such liabilities, 2.70% and 1.98% in fiscal years 2005 and 2004, respectively. As short-term rates moved higher during 2005, interest expense increased as we priced our deposit products to meet the competition and the adjustable rates paid on other borrowings increased as well. In April 2005 and May 2004, we sold $7.22 million and $15.46 million, respectively, of floating rate junior subordinated debentures which mature in 2035 and 2034, respectively. The net proceeds of said sales were used to augment the Bank's capital. The additional interest expense on these debentures, which is included in other borrowings, was $1.27 million and $463,000 during fiscal 2005 and 2004.

	Fiscal 2005		Fiscal 2004	
	Interest Expense	% of Total	Interest Expense	% Tot
	(In thousands, except percentages)			
Interest-Bearing Deposits	$ 4,639	20.71%	$ 3,809	23.9
Time Deposits	9,552	42.64	6,024	37.8
Other Borrowings	8,208	36.65	6,083	38.2
Total Interest Expense	$ 22,399	100.00%	$15,916	100.0

	Fiscal 2005		F
	Average Amount	% of Total	Averag Amount
	(In thousands, except percentag		
Interest-Bearing Deposits	$264,130	31.88%	$272
Time Deposits	338,834	40.89	309
Other Borrowings	225,657	27.23	223
Total Interest-Bearing Liabilities	$828,621	100.00%	$805

Non-Interest Income. Non-interest income consists primarily of realized gains on sales of marketable securities and service fee income. For the fiscal year ended December 31, 2005, total non-interest income decreased by $613,000 to $1.21 million from $1.82 million for the fiscal year ended December 31, 2004. In 2004, we recorded gains of $793,000 on the sales and issuer redemptions of investment securities. In 2005, such gains amounted to $4,000. Service charges on deposit accounts increased by $69,000 to $589,000 in fiscal 2005 from $520,000 in fiscal 2004.

	Fiscal 2005		Fiscal 200
	Non-Interest Income	% of Total	Non-Interest Income
	(In thousands, except percentages)		
Service Charges on Deposits	$ 589	48.84%	$ 520
Investment Securities gains	4	0.33	793
Other	613	50.83	506
Total Non-Interest Income	$1,206	100.00%	$1,819

Non-Interest Expense. Non-interest expense includes salaries and employee benefits, occupancy and equipment expenses, legal and professional fees and other operating expenses associated with the day-to-day operations of the Company. Total non-interest expense for the year ended December 31, 2005 increased by $1.04 million, or 8.63%, to $13.14 million from $12.10 million for the year ended December 31, 2004. The largest component of non-interest expense are salaries and employee benefits which increased by $1.12 million, or 16.21%, to $8.00 million in fiscal 2005 from $6.89 million in fiscal 2004. The increase is due to the addition of personnel in our internal control and compliance departments.

	Fiscal 2005		Fiscal
	Non-Interest Expense	% of Total	Non-Interest Expense
	(In thousands, except percentages)		
Salaries and Employee Benefits	$ 8,002	60.90%	$ 6,88
Net Occupancy Expense	1,728	13.15	1,53
Equipment Expense	397	3.02	35
FDIC Assessment	272	2.07	11
Data Processing Expense	198	1.51	15
Other	2,542	19.35	3,04
Total Non-Interest Expense	$13,139	100.00%	$12,09

Provision for Income Tax. During the years ended December 31, 2005 and 2004, we recorded income tax expense of $5.00 million and $6.13 million, respectively. The tax provisions for federal, state and local taxes recorded for 2005 and 2004 represent effective tax rates of 47.45% and 44.98%, respectively.

Common Stock Repurchases

On May 15, 2003, The Company's Board of Directors authorized the purchase of up to an additional 450,000 shares of its Common Stock in the open market, from time to time, depending upon prevailing market conditions, thereby increasing the maximum number of shares which may be purchased by the Company from 1,950,000 shares of Common Stock to 2,400,000 shares of Common Stock. Since 1990 through December 31, 2003, the Company has purchased a total of 1,844,646 shares of its Common Stock. During fiscal year 2004, we purchased a total of 4,263 shares and at December 31, 2005 there were 551,091 shares of Common Stock which may yet be purchased under our stock repurchase plan. The following table sets forth information with respect to such purchases during the periods indicated.

Fiscal Year 2005

	Number of Shares Purchased	Average Price Paid Per Share
January - December	--	--

Fiscal Year 2004

	Number of Shares Purchased	Average Price Paid Per Share
January	4,263	$ 16.33
February - March	--	--
April - June	--	--
July - September	--	--
October - December	--	--

Results of Operations Fiscal Year Ended December 31, 2004 Compared to Fiscal Year Ended December 31, 2003.

General.

References to per share amounts below, unless stated otherwise, refer to diluted shares. References to per share amounts for the fiscal years ended December 31, 2003 have been revised to reflect the reverse stock split and stock dividend which occurred on May 18, 2004.

Net Income. Net income for the fiscal year ended December 31, 2004 was $7.50 million, or $1.10 per share, as compared to $7.42 million, or $1.10 per share, for the fiscal year ended December 31, 2003.

The Company's net income is largely dependent on interest rate levels, the demand for the Company's loan and deposit products and the strategies employed to manage the interest rate and other risks inherent in the banking business. From June 2003 through June 30, 2004, interest rates, as measured by the prime rate, remained constant at 4.00%. On July 1, 2004, inflation fighting actions taken by the Federal Reserve Board resulted in a 25 basis point increase in the prime rate to 4.25%, the first such increase in more than four years. Similar 25 basis point moves taken by the Federal Reserve Board in August, September, November and December of 2004, and February 2005 moved the prime rate to 5.50%.

Net Interest Income. The Company's primary source of revenue is net interest income, or the difference between interest income on earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities such as deposits and borrowings.

For the fiscal year ended December 31, 2004, net interest income increased by $3.31 million, or 15.94%, to $24.09 million from $20.78 million for the fiscal year ended December 31, 2003. The increase in net interest income was the result of a 19.55% growth in the average amount of interest-earning assets to $915.66 million at the end of 2004 from $765.94 million at the end of 2003, partially offset by the 21.93% growth in the average amount of interest-bearing liabilities to $805.40 million from $660.54 million at December 31, 2004 and 2003, respectively, as well as the interest-rate spread or the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

During fiscal 2004, the average yield on interest-earning assets fell to 4.37% from 4.49% in fiscal 2003, a decline of 2.67%, while the average cost of interest-bearing liabilities fell to 1.98% from 2.07%, a decline of 4.35% The interest-rate spread decreased to 2.39% during fiscal 2004 from 2.42% during fiscal 2003.

If interest rates remain at current levels or increase slowly over time, we expect to see only moderate pressure on the Company's interest-rate spread and net interest income. Investment securities in our portfolio that have been sold, matured or called by the issuer during fiscal 2003 and 2004 have been replaced with securities carrying somewhat lower yields and, by design, shorter maturities to hedge against a rising interest rate environment. Rates paid on deposit accounts are likely to increase in a rising rate environment due to competition for deposits in the market place. The cost of borrowed funds with floating rather than fixed interest rates will increase as well.

Net Interest Margin. Net interest margin, or annualized net interest income as a percentage of average interest-earning assets, declined to 2.63% in fiscal 2004 from 2.71% in fiscal 2003. We seek to secure and retain customer deposits with competitive products and rates, while making strategic use of the prevailing interest rate environment to borrow funds at what we believe to be attractive rates. We invest such deposits and borrowed funds in a prudent mix of fixed rate and adjustable rate loans, investment securities and short-term interest-earning assets which provided an aggregate average yield of 4.37% and 4.49% in fiscal 2004 and 2003, respectively.

The average amount of loans decreased slightly to $290.77 million in fiscal 2004 from $291.59 million in fiscal 2003, as did the average yield on the loan portfolio which declined to 6.47% in fiscal 2004 from 6.54% in fiscal 2003. During periods of low and stable interest rates, as was the case during 2003, borrowers gravitate towards fixed-rate loans to lock in a low interest rate, whereas adjustable rate loans are generally preferred when interest rates are trending higher. One-to-four family mortgage loans, approximately 54% and 57% of our loan portfolio at December 31, 2004 and 2003, respectively, are particularly sensitive to changes in interest rates.

The average amount of investment securities increased by $150.10 million to $620.51 million in fiscal 2004 from $470.41 million in fiscal 2003. The average yield on investment securities improved by 14 basis points, to 3.40% in 2004 from 3.26% in 2003 and are likely to continue to increase in a rising interest rate environment.

Interest Income. Total interest income for the fiscal year ended December 31, 2004 increased by $5.58 million, or 16.21%, to $40.01 million from $34.43 million for the fiscal year ended December 31, 2003. The increase in interest income was primarily due to the growth in the average amount of total interest-earning assets. Loans contributed $18.83 million of interest income in fiscal 2004, a decline of $236,000 from the $19.06 million of interest income contributed in fiscal 2003. Investment securities contributed $21.12 million of interest income in fiscal 2004, an increase of 37.85% over the $15.32 million of interest income earned on loans in fiscal 2003.

	Fiscal 2004		Fiscal 2003	
	Interest Income	% of Total	Interest Income	% of Total
	(In thousands, except percentages)			
Loans	$18,825	47.05%	$19,061	55.37%
Investment Securities	21,120	52.79	15,321	44.50
Other	63	0.16	44	0.13
Total Interest Income	$40,008	100.00%	$34,426	100.00%

Loans, which are inherently risky and therefore command a higher return than our conservative portfolio of investment securities, declined to 31.76% of our total average interest-earning assets in fiscal 2004 from 38.07% in fiscal 2003. While we actively seek to originate new loans with qualified borrowers who meet the Bank's underwriting standards, our strategy has been to maintain those standards, sacrificing some current income to avoid possible large future losses in the loan portfolio.

	Fiscal 2004		Fiscal 2
	Average Amount	% of Total	Average Amount
	(In thousands, except percentages)		
Loans	$290,774	31.76%	$291,586
Investment Securities	620,511	67.77	470,412
Other	4,376	0.47	3,946
Total Interest-Earning Assets	$915,661	100.00%	$765,944

Interest Expense. Total interest expense for the fiscal year ended December 31, 2004 increased by $2.27 million, or 16.63%, to $15.92 million from $13.65 million for the fiscal year ended December 31, 2003. The increase in interest expense was due primarily to the growth in the average amount of interest-bearing liabilities, partially offset by the decline in the average rate paid on such liabilities, 1.98% and 2.07% in fiscal years 2004 and 2003, respectively. As rates move higher, interest expense will increase as we price our deposit products to meet the competition and the adjustable rates paid on other borrowings increase as well. In May 2004, we sold $15.46 million of floating rate junior subordinated debentures which mature in 2034 and used the net proceeds to augment the Bank's capital. The additional interest expense on these debentures, which are included in other borrowings, was $463,000 during fiscal 2004.

	Fiscal 2004		Fiscal 2003	
	Interest Expense	% of Total	Interest Expense	% Tot
	(In thousands, except percentages)			
Interest-Bearing Deposits	$ 3,809	23.93%	$ 2,593	19.0
Time Deposits	6,024	37.85	7,537	55.2
Other Borrowings	6,083	38.22	3,517	25.7
Total Interest Expense	$15,916	100.00%	$13,647	100.0

	Fiscal 2004		F
	Average Amount	% of Total	Averag Amount
	(In thousands, except percentag		
Interest-Bearing Deposits	$272,219	33.80%	$201
Time Deposits	309,968	38.49	333
Other Borrowings	223,208	27.71	125
Total Interest-Bearing Liabilities	$805,395	100.00%	$660

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Non-Interest Income. Non-interest income consists primarily of realized gains on sales of marketable securities and service fee income. For the fiscal year ended December 31, 2004, total non-interest income decrease by $2.16 million to $1.82 million from $3.98 million for the fiscal year ended December 31, 2003. In 2003, we recorded gains of $2.75 million on the sales and issuer redemptions of investment securities. In 2004, such gains amounted to $793,000. Service charges on deposit accounts decreased by $120,000 to $520,000 in fiscal 2004 from $640,000 in fiscal 2003. The decline is primarily due to marketing efforts introducing new deposit products, which includes the waiver of such fees for a period of time to attract new customers.

	Fiscal 2004		Fiscal 200
	Non-Interest Income	% of Total	Non-Interest Income
	(In thousands, except percentages)		
Service Charges on Deposits	$ 520	28.59%	$ 640
Investment Securities gains	793	43.60	2,746
Other	506	27.81	597
Total Non-Interest Income	$1,819	100.00%	$3,983

Non-Interest Expense. Non-interest expense includes salaries and employee benefits, occupancy and equipment expenses, legal and professional fees and other operating expenses associated with the day-to-day operations of the Company. Total non-interest expense for the year ended December 31, 2004 increased by $632,000, or 5.51%, to $12.10 million from $11.46 million for the year ended December 31, 2003. The largest component of non-interest expense are salaries and employee benefits which increased by $1.01 million, or 17.25%, to $6.89 million in fiscal 2004 from $5.87 million in fiscal 2003. The increase is due to the additional staffing of our two new Brooklyn branches which opened in April and June of 2003 and the addition of personnel in our internal control and compliance departments.

	Fiscal 2004	Fiscal