

FIRST CHARTER CORP /NC/

Form 10-Q

May 09, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2005

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 0-15829

**FIRST CHARTER CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**North Carolina**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**56-1355866**  
(I.R.S. Employer  
Identification No.)

**10200 David Taylor Drive, Charlotte, NC**  
(Address of Principal Executive Offices)

**28262-2373**  
(Zip Code)

Registrant's telephone number, including area code **(704) 688-4300**

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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes  No

As of May 6, 2005 the Registrant had outstanding 30,386,262 shares of Common Stock, no par value.

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**First Charter Corporation**

**Form 10-Q for the Quarterly Period Ended March 31, 2005**

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**Table of Contents****PART 1. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****First Charter Corporation and Subsidiaries****Consolidated Balance Sheets**

	<b>March 31 2005 (Unaudited)</b>	December 31 2004
<i>(Dollars in thousands, except share data)</i>		
<b>Assets:</b>		
Cash and due from banks	\$ 110,745	\$ 90,238
Federal funds sold	1,951	1,589
Interest bearing bank deposits	5,507	6,184
Cash and cash equivalents	118,203	98,011
Securities available for sale (cost of \$1,466,459 and \$1,660,703; carrying amount of pledged collateral \$998,742 and \$1,140,234)	1,440,494	1,652,732
Loans held for sale	6,006	5,326
Loans	2,704,422	2,439,692
Less: Unearned income	(232)	(291)
Allowance for loan losses	(27,483)	(26,872)
Loans, net	2,676,707	2,412,529
Premises and equipment, net	98,616	97,565
Goodwill and other intangible assets	21,473	21,594
Other assets	151,554	143,848
<b>Total assets</b>	<b>\$ 4,513,053</b>	<b>\$ 4,431,605</b>
<b>Liabilities:</b>		
Deposits, domestic:		
Noninterest bearing demand	\$ 402,986	\$ 377,793
Interest bearing	2,299,722	2,232,053
Total deposits	2,702,708	2,609,846
Short-term borrowings	803,124	685,998
Long-term borrowings	648,632	763,738
Other liabilities	46,335	57,336
<b>Total liabilities</b>	<b>4,200,799</b>	<b>4,116,918</b>

**Shareholders equity:**

Preferred stock no par value; authorized 2,000,000 shares; no shares issued and outstanding		
Common stock no par value; authorized 100,000,000 shares; issued and outstanding <b>30,275,766</b> and 30,054,256 shares	<b>125,309</b>	121,464
Common stock held in Rabbi Trust for deferred compensation	<b>(834)</b>	(808)
Deferred compensation payable in common stock	<b>834</b>	808
Retained earnings	<b>202,657</b>	198,085
Accumulated other comprehensive loss:		
Unrealized loss on securities available for sale, net	<b>(15,712)</b>	(4,862)
<b>Total shareholders equity</b>	<b>312,254</b>	314,687
<b>Total liabilities and shareholders equity</b>	<b>\$ 4,513,053</b>	\$ 4,431,605

See accompanying notes to consolidated financial statements.

**Table of Contents****First Charter Corporation and Subsidiaries****Consolidated Statements of Income  
(Unaudited)****For the Three  
Months Ended March 31***(Dollars in thousands, except share and per share data)*

	<b>2005</b>	<b>2004</b>
<b>Interest income:</b>		
Loans	\$ 36,446	\$ 29,193
Federal funds sold	9	3
Interest bearing bank deposits	43	44
Securities	14,784	15,990
Total interest income	<b>51,282</b>	45,230
<b>Interest expense:</b>		
Deposits	10,514	8,125
Federal funds purchased and securities sold under agreements to repurchase	1,327	583
Federal Home Loan Bank and other borrowings	8,867	6,149
Total interest expense	<b>20,708</b>	14,857
<b>Net interest income</b>	<b>30,574</b>	30,373
<b>Provision for loan losses</b>	<b>1,900</b>	3,000
<b>Net interest income after provision for loan losses</b>	<b>28,674</b>	27,373
<b>Noninterest income:</b>		
Service charges on deposit accounts	6,236	5,605
Financial management income	1,580	1,502
(Loss) gain on sale of securities	(49)	326
Loss from equity method investments	(58)	(224)
Mortgage services income	394	428
Brokerage services income	802	970
Insurance services income	3,512	3,031
Bank owned life insurance	827	850
Gain on sale of properties	529	777
Other	2,041	1,400
Total noninterest income	<b>15,814</b>	14,665
<b>Noninterest expense:</b>		
Salaries and employee benefits	15,569	15,023
Occupancy and equipment	4,381	4,237
Data processing	1,321	862
Marketing	1,080	1,118

Postage and supplies	<b>1,208</b>	1,271
Professional services	<b>1,913</b>	2,712
Telephone	<b>528</b>	494
Amortization of intangibles	<b>131</b>	118
Other	<b>2,738</b>	2,473
Total noninterest expense	<b>28,869</b>	28,308
<b>Income before income taxes</b>	<b>15,619</b>	13,730
<b>Income tax expense</b>	<b>5,310</b>	4,490
<b>Net income</b>	<b>\$ 10,309</b>	\$ 9,240
<b>Net income per share:</b>		
Basic	<b>\$ 0.34</b>	\$ 0.31
Diluted	<b>\$ 0.34</b>	\$ 0.31
<b>Weighted average shares:</b>		
Basic	<b>30,234,683</b>	29,738,553
Diluted	<b>30,630,601</b>	30,029,056

See accompanying notes to consolidated financial statements.



Table of Contents**First Charter Corporation and Subsidiaries****Consolidated Statements of Shareholders Equity**

(Unaudited)

	Common Stock		Common Stock held in Rabbi Trust for Compensation Payable	Deferred Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Common Stock	in Common Stock	Earnings	(Loss)	
<i>(Dollars in thousands, except share data)</i>							
<b>Balance, December 31, 2003</b>	29,720,163	\$ 115,270	\$ (636)	\$ 636	\$ 178,008	\$ 6,161	\$ 299,439
Comprehensive income:							
Net income					9,240		9,240
Unrealized gain on securities available for sale, net						5,098	5,098
Total comprehensive income							14,338
Common stock purchased by Rabbi Trust for deferred compensation			(70)				(70)
Deferred compensation payable in common stock				70			70
Cash dividends					(5,501)		(5,501)
Stock options exercised	28,017	461					461
Balance, March 31, 2004	29,748,180	\$ 115,731	\$ (706)	\$ 706	\$ 181,747	\$ 11,259	\$ 308,737
<b>Balance, December 31, 2004</b>	<b>30,054,256</b>	<b>\$ 121,464</b>	<b>\$ (808)</b>	<b>\$ 808</b>	<b>\$ 198,085</b>	<b>\$ (4,862)</b>	<b>\$ 314,687</b>
Comprehensive loss:							
Net income					10,309		10,309
Unrealized loss on securities available for sale, net						(10,850)	(10,850)
Total comprehensive loss							(541)
Common stock purchased by Rabbi Trust for deferred compensation			(26)				(26)
Deferred compensation payable in common stock				26			26
Cash dividends					(5,737)		(5,737)
Stock options exercised and Dividend Reinvestment Plan stock issued	215,010	3,692					3,692

Restricted stock issued	<b>6,500</b>	<b>153</b>						<b>153</b>
<b>Balance, March 31, 2005</b>	<b>30,275,766</b>	<b>\$ 125,309</b>	<b>\$ (834)</b>	<b>\$ 834</b>	<b>\$ 202,657</b>	<b>\$ (15,712)</b>	<b>\$ 312,254</b>	

See accompanying notes to consolidated financial statements.

**Table of Contents****First Charter Corporation and Subsidiaries****Consolidated Statements of Cash Flows**

(Unaudited)

	<b>Three Months Ended March 31</b>	
	<b>2005</b>	<b>2004</b>
<i>(Dollars in thousands)</i>		
<b>Cash flows from operating activities:</b>		
Net income	\$ 10,309	\$ 9,240
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,900	3,000
Depreciation	2,352	2,250
Amortization of intangibles	131	118
Premium amortization and discount accretion, net	591	929
Net loss (gain) on securities available for sale transactions	49	(326)
Net loss (gain) on sale of foreclosed assets	123	(45)
Write-downs on foreclosed assets	117	106
Net (gain) loss on sale of equipment	(21)	1
Loss from equity method investments	58	224
Net gain on sale property	(529)	(777)
Origination of mortgage loans held for sale	(27,666)	(18,903)
Proceeds from sale of mortgage loans held for sale	26,987	6,071
Increase in cash surrender value of bank owned life insurance	(827)	(850)
Decrease (increase) in other assets	4,682	(2,793)
(Decrease) increase in other liabilities	(11,002)	7,151
Net cash provided by operating activities	7,254	5,396
<b>Cash flows from investing activities:</b>		
Proceeds from sales of securities available for sale	157,897	20,348
Proceeds from maturities of securities available for sale	42,935	115,449
Purchase of securities available for sale	(7,228)	(149,173)
Net increase in loans	(270,565)	(36,703)
Proceeds from sale of loans		5,828
Proceeds from sales of other real estate	443	1,245
Net purchases of premises and equipment	(3,382)	(860)
Net cash used in investing activities	(79,900)	(43,866)
<b>Cash flows from financing activities:</b>		
Net increase in demand, money market and savings accounts	6,521	75,934
Net increase in certificates of deposit	86,342	3,610
Net increase (decrease) in securities sold under repurchase agreements and other borrowings	2,020	(54,826)
Proceeds from issuance of common stock	3,692	461
Dividends paid	(5,737)	(5,501)

Net cash provided by financing activities	<b>92,838</b>	19,678
Net increase (decrease) in cash and cash equivalents	<b>20,192</b>	(18,792)
Cash and cash equivalents at beginning of period	<b>98,011</b>	113,506
<b>Cash and cash equivalents at end of period</b>	<b>\$ 118,203</b>	\$ 94,714
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid for interest	<b>\$ 20,113</b>	\$ 15,836
Cash paid for income taxes	<b>10,104</b>	207
<b>Supplemental disclosure of non-cash transactions:</b>		
Transfer of loans and premises and equipment to other real estate	<b>4,487</b>	776
Unrealized (loss) gain on securities available for sale (net of tax effect of (\$7,144) and \$3,196, respectively)	<b>(10,850)</b>	5,098
Allowance related to loans sold		549

See accompanying notes to consolidated financial statements.

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**First Charter Corporation and Subsidiaries**

**Notes to Interim Consolidated Financial Statements (Unaudited) For the Three Months Ended March 31, 2005 and 2004**

First Charter Corporation (the Corporation) is a regional financial services company with assets of approximately \$4.51 billion and is the holding company for First Charter Bank (First Charter or the Bank). The Bank is a full-service bank and trust company with 53 financial centers, seven insurance offices and 101 ATMs located in 18 counties throughout the piedmont and western half of North Carolina. The Bank also operates mortgage origination offices in Raleigh, NC and Reston, VA. The Bank provides businesses and individuals with a broad range of financial services, including banking, financial planning, funds management, investments, insurance, mortgages and a full array of employee benefit programs.

**Note One Accounting Policies**

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiary, the Bank. In consolidation, all intercompany accounts and transactions have been eliminated.

The information contained in the consolidated financial statements, excluding information as of the fiscal year ended December 31, 2004, is unaudited. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, as well as the amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

The information furnished in this report reflects all adjustments which are, in the opinion of management, necessary to present a fair statement of the financial condition and the results of operations for interim periods. All such adjustments are of a normal and recurring nature. Certain amounts reported in prior periods have been reclassified to conform to the current period presentation. Such reclassifications have no effect on net income or shareholders' equity as previously reported.

Accounting policies followed by the Corporation are presented on pages 56 to 65 of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2004. These policies have not materially changed from that disclosure.

*Recently Adopted Accounting Pronouncements*

In December 2003, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 03-03 (SOP 03-03), which addresses the accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. SOP 03-03 includes loans acquired in purchase business combinations and applies to all nongovernmental entities. SOP 03-03 does not apply to loans originated by the entity. SOP 03-03 is effective for loans acquired in fiscal years beginning after December 15, 2004. The Corporation adopted SOP 03-03 effective January 2005 with no material effect on its consolidated financial statements.

In October 2004, Congress enacted the American Jobs Creation Act of 2004 (the 2004 Act). Under this legislation, non-qualified deferred compensation plans are subject to new rules governing the income tax treatment of contributions and distributions related to these plans. The 2004 Act could provide less favorable overall income tax treatment for mutual fund option investments beginning in 2005. As a result, participants in the First Charter Option

Plan Trust and the First Charter Corporation Directors Option Deferral Plan may direct the administrative committee to invest their 2005 deferrals directly into mutual funds while the Corporation reviews further guidance from the Internal Revenue Service with respect to the mutual fund option investments. The Corporation does not anticipate any material effects on its consolidated financial statements from the 2004 Act.

**Table of Contents****Note Two Net Income Per Share**

Basic net income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding for the three months ended March 31, 2005 and 2004, respectively. Diluted net income per share reflects the potential dilution that could occur if the Corporation's potential common stock and contingently issuable shares, which consist of dilutive stock options and restricted stock, were issued. The numerators of the basic net income per share computations are the same as the numerators of the diluted net income per share computations for all periods presented.

A reconciliation of the basic average common shares outstanding to the diluted average common shares outstanding is as follows:

	<b>Three Months Ended March 31</b>	
	<b>2005</b>	2004
Basic weighted average number of common shares outstanding	<b>30,234,683</b>	29,738,553
Dilutive effect arising from potential common stock issuances	<b>395,918</b>	290,503
Diluted weighted average number of common shares outstanding	<b>30,630,601</b>	30,029,056

The effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per share. These amounts were 992 thousand shares for the three months ended March 31, 2005 and 845 thousand shares for the comparable 2004 period.

Dividends declared by the Corporation were \$0.19 per share for the three months ended March 31, 2005 and \$0.185 per share for the comparable 2004 period.

**Note Three Business Segment Information**

The Corporation has only one reportable segment, the Bank, the Corporation's primary banking subsidiary. The Bank provides businesses and individuals with commercial loans, retail loans, and deposit banking services. Other Operating Segments include brokerage, insurance, mortgage, leasing and investments, and financial management, which provide comprehensive financial planning and investments. The results of operations of the Bank constitute a substantial majority of the consolidated net income, revenues and assets of the Corporation. Included in Other are revenue, expenses and assets of the parent company, which include cash, equity investments and investments in venture capital limited partnerships, and eliminating intercompany transactions.

Business segments are determined based on the Corporation's internal management accounting process. The internal management accounting process, unlike financial accounting in accordance with generally accepted accounting principles, is based on the method management uses to view its business and is not necessarily comparable with information disclosed by other financial institutions. The accounting policies of the business segments differ from those described in *Note One* in that management allocations have been made for overhead expenses. Certain expenses not directly attributable to a specific business segment are allocated to the segments based on pre-determined means. Occupancy costs are allocated based on headcount and certain payroll benefits are allocated based on a predetermined percentage of salary expense. The results of operations and segment assets are based upon monthly internal management reports. There are no significant intersegment transactions, and there are no significant

reconciling items between the reportable segments and consolidated amounts.



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Information regarding the reportable segment's separate results of operations and segment assets is illustrated in the following tables:

**March 31, 2005**

<i>(Dollars in thousands)</i>	The Bank	Other Operating Segments	Other	Totals
<b>Total interest income</b>	\$ 50,857	\$ 408	\$ 17	\$ 51,282
<b>Total interest expense</b>	20,466		242	20,708
<b>Net interest income</b>	30,391	408	(225)	30,574
<b>Provision for loan losses</b>	1,900			1,900
<b>Total noninterest income</b>	9,540	6,291	(17)	15,814
<b>Total noninterest expense</b>	22,809	6,010	50	28,869
<b>Net income (loss) before income taxes</b>	15,222	689	(292)	15,619
<b>Income taxes expense (benefit)</b>	5,176	233	(99)	5,310
<b>Net income (loss)</b>	\$ 10,046	\$ 456	\$ (193)	\$ 10,309
<b>Total loans held for sale and loans, net</b>	\$ 2,673,932	\$ 8,781	\$	\$ 2,682,713
<b>Total assets</b>	4,412,238	83,333	17,482	4,513,053

**March 31, 2004**

<i>(Dollars in thousands)</i>	The Bank	Other Operating Segments	Other	Totals
<b>Total interest income</b>	\$ 45,190	\$ 19	\$ 21	\$ 45,230
<b>Total interest expense</b>	14,659	6	192	14,857
<b>Net interest income</b>	30,531	13	(171)	30,373
<b>Provision for loan losses</b>	3,000			3,000
<b>Total noninterest income</b>	8,552	6,016	97	14,665
<b>Total noninterest expense</b>	22,690	5,572	46	28,308
<b>Net income (loss) before income taxes</b>	13,393	457	(120)	13,730
<b>Income taxes expense (benefit)</b>	4,379	150	(39)	4,490
<b>Net income (loss)</b>	\$ 9,014	\$ 307	\$ (81)	\$ 9,240
<b>Total loans held for sale and loans, net</b>	\$ 2,253,074	\$ 19,025	\$	\$ 2,272,099
<b>Total assets</b>	4,177,763	46,323	23,775	4,247,861

**Note Four Goodwill and Other Intangible Assets**

The following is a summary of the gross carrying amount and accumulated amortization of amortized intangible assets and the carrying amount of unamortized intangible assets as of March 31, 2005 and December 31, 2004:

	March 31, 2005		December 31, 2004	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
<i>(Dollars in thousands)</i>				
Amortized intangible assets:				
Noncompete agreements	\$ 1,037	\$ 956	\$ 1,037	\$ 949
Customer lists	2,270	655	2,270	545
Mortgage servicing rights	7,557	6,075	7,557	5,910
Branch acquisitions	1,111	1,111	1,111	1,111
Other intangibles <sup>(1)</sup>	306	85	306	72
<b>Total</b>	<b>\$ 12,281</b>	<b>\$ 8,882</b>	<b>\$ 12,281</b>	<b>\$ 8,587</b>
Unamortized intangible assets:				
Goodwill <sup>(2)</sup>	\$ 19,556	\$	\$ 19,547	\$

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(1) Other intangibles include trade name and proprietary software.

(2) Goodwill of \$6,671 is recorded in the Other Operating Segments and \$12,885 is recorded in FCB as described in **Note Two**

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Amortization expense, excluding amortization of mortgage servicing rights, totaled \$131 thousand and \$118 thousand for the three months ended March 31, 2005 and 2004, respectively.

The following table presents the estimated amortization expense for intangible assets for the years ended December 31, 2005, 2006, 2007, 2008, 2009, and 2010 and thereafter:

<i>(Dollars in thousands)</i>	Noncompetitive		Customer	Mortgage	Other	Total
	Agreements	Lists	Lists	Servicing Rights	Intangibles	
2005	\$ 30	\$ 415		\$ 515	\$ 51	\$ 1,011
2006	30	353		377	45	805
2007	28	290		281	39	638
2008		228		186	32	446
2009		165		117	26	308
2010 and after		274		171	41	486
<b>Total</b>	<b>\$ 88</b>	<b>\$ 1,725</b>		<b>\$ 1,647</b>	<b>\$ 234</b>	<b>\$ 3,694</b>

**Note Five Comprehensive Income**

Comprehensive income is defined as the change in equity from all transactions other than those with stockholders, and it includes net income and other comprehensive income. The Corporation's only component of other comprehensive income is the change in unrealized gains and losses on available for sale securities.

The Corporation's total comprehensive income for the three months ended March 31, 2005 was a loss of \$0.5 million compared to total comprehensive income for the three months ended March 31, 2004 of \$14.3 million. Information concerning the Corporation's other comprehensive income for three months ended March 31, 2005 and 2004 is as follows:

<i>(Dollars in thousands)</i>	For the Three Months Ended March 31,					
	2005			2004		
	Pre-Tax Amount	Tax Effect	After Tax Amount	Pre-Tax Amount	Tax Effect	After Tax Amount
<b>Comprehensive income:</b>						
Net income	\$ 15,619	\$ 5,310	\$ 10,309	\$ 13,730	\$ 4,490	\$ 9,240
<b>Other comprehensive (loss) income:</b>						
Unrealized (losses) gains on securities:						
Unrealized (losses) gains arising during period	(18,043)	(7,163)	(10,880)	8,620	3,323	5,297
Less: Reclassification for realized (losses) gains	(49)	(19)	(30)	326	127	199

Unrealized (losses) gains, net of reclassification	\$ (17,994)	\$ (7,144)	\$ (10,850)	\$ 8,294	\$ 3,196	\$ 5,098
Total comprehensive (loss) income	\$ (2,375)	\$ (1,834)	\$ (541)	\$ 22,024	\$ 7,686	\$ 14,338

**Table of Contents****Note Six Securities-Available-for-Sale**

Securities-available-for-sale at March 31, 2005 and December 31, 2004 are summarized as follows:

<i>(Dollars in thousands)</i>	March 31, 2005			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
US government obligations	\$ 29,781	\$ 143	\$ 449	\$ 29,475
US government agency obligations	637,135	252	13,967	623,420
Mortgage-backed securities	621,786	661	14,267	608,180
State, county, and municipal obligations	113,369	1,855	277	114,947
Equity securities	64,388	84		64,472
<b>Total</b>	<b>\$ 1,466,459</b>	<b>\$ 2,995</b>	<b>\$ 28,960</b>	<b>\$ 1,440,494</b>

<i>(Dollars in thousands)</i>	December 31, 2004			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
US government obligations	\$ 54,755	\$ 331	\$ 712	\$ 54,374
US government agency obligations	697,083	908	6,021	691,970
Mortgage-backed securities	731,389	3,349	8,357	726,381
State, county, and municipal obligations	112,935	2,568	123	115,380
Equity securities	64,541	86		64,627
<b>Total</b>	<b>\$ 1,660,703</b>	<b>\$ 7,242</b>	<b>\$ 15,213</b>	<b>\$ 1,652,732</b>

Securities with an aggregate carrying value of \$998.7 million at March 31, 2005 were pledged to secure public deposits, securities sold under agreements to repurchase and Federal Home Loan Bank FHLB borrowings.

Gross gains and losses recognized on the sale of securities are summarized as follows:

<i>(Dollars in thousands)</i>	Three months ended March 31,	
	2005	2004
Gross gains	\$ 1,196	\$ 686
Gross losses	(1,245)	(360)
<b>Net (losses) gains</b>	<b>\$ (49)</b>	<b>\$ 326</b>

At March 31, 2005 and December 31, 2004, the Bank owned stock in the Federal Home Loan Bank of Atlanta with a cost basis (par value) of \$59.1 million and \$59.3 million, respectively, which is included in equity securities. While these securities have no quoted fair value, they are redeemable at par value from the FHLB. In addition, the Bank owned Federal Reserve Bank stock with a cost basis (par value) of \$4.1 million at both March 31, 2005 and December 31, 2004, which is included in equity securities.

At March 31, 2005, mortgage-backed securities of \$577.3 million were considered temporarily impaired. Mortgage-backed securities are investment grade securities backed by a pool of mortgages or trust deeds. Principal and interest payments on the underlying mortgages are used to pay monthly interest and principal on the securities. Because some mortgage pools will pay off faster than others, mortgaged-backed securities are typically issued as a series of several different bonds, each having a different maturity date. U.S. government agency obligations of \$597.1 million were considered temporarily impaired at March 31, 2005. U.S. government agency obligations are interest-bearing debt securities of U.S.

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government agencies (i.e. FNMA and FHLMC). U.S. government obligations of \$14.5 million were considered temporarily impaired at March 31, 2005. These obligations are securities issued by the U.S. Treasury. State, county and municipal obligations of \$15.3 million were considered temporarily impaired at March 31, 2005. These obligations are debt instruments that are obligations of a state, county or municipality.

The unrealized losses shown in the following table resulted primarily from an increase in short-term and intermediate rates.

As of March 31, 2005

	<b>Less than 12 months</b>		<b>12 months or longer</b>		<b>Total</b>	
	Gross		Gross		Gross	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<i>(Dollars in thousands)</i>	Value	Losses	Value	Losses	Fair Value	Losses
US government obligations	\$ 4,823	\$ (118)	\$ 9,688	\$ (331)	\$ 14,511	\$ (449)
US government agency obligations	408,675	(7,554)	188,470	(6,413)	597,145	(13,967)
Mortgage-backed securities	244,101	(3,946)	333,231	(10,321)	577,332	(14,267)
State, county and municipal obligations	8,111	(47)	7,149	(230)	15,260	(277)
<b>Total temporarily impaired securities</b>	<b>\$ 665,710</b>	<b>\$ (11,665)</b>	<b>\$ 538,538</b>	<b>\$ (17,295)</b>	<b>\$ 1,204,248</b>	<b>\$ (28,960)</b>

Investments that are in a gross unrealized loss position include three U.S. government obligations, forty-seven U.S. agency securities, forty-five mortgage-backed securities and thirteen municipal obligations. The unrealized losses associated with these securities are not considered to be other-than-temporary, because they are related to changes in interest rates and do not affect the expected cash flows of the underlying collateral or the issuer. In addition, investments that have been in an unrealized loss position for longer than one year have an external credit rating of AA1 or higher. At March 31, 2005, the Corporation has the ability to hold these investments to maturity.

**Note Seven Derivatives**

The Corporation accounts for interest rate swaps as a hedge of the fair value of designated liabilities. For both the three months ended March 31, 2005 and 2004, the Corporation recognized a net loss of \$1 thousand for the ineffective portion of the interest rate swaps. At March 31, 2005, the derivative hedging instruments were recorded at fair value in other assets. These instruments had gross unrealized gains of \$0.9 million and gross unrealized losses of \$10.2 million at March 31, 2005.

Information concerning the Corporation's derivative instruments for the three months ended March 31, 2005 is as follows:

	Notional	Average	Average	March 31, 2005				
				Receive	Pay	Average	Fair Value	
				Rate	Rate	Remaining	Gains	Losses
<i>(Dollars in thousands)</i>	Amount	Rate	Rate	Maturity in	Years			

Fair Value Hedges:

Interest rate swaps	\$ 222,000	5.16%	4.39%	5.00	\$ 908	\$(10,249)	\$	(1)
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According to the provisions of SFAS No. 133, the short cut method assumes that the change in the fair value of the derivative hedging instrument and the hedged debt obligation is one hundred percent correlated, which results in no ineffectiveness and no income statement effect. Of the \$222.0 million aggregate notional amount of interest rate swap agreements entered into during 2004, three out of seven agreements totaling \$90.0 million qualify for the short cut method; therefore, there was no impact on earnings during the three months ended March 31, 2005 from those interest rate swap agreements.

**Note Eight Loans and Allowance for Loan Losses**

The Corporation's primary market area includes North Carolina, and predominately centers around the Metro region of Charlotte, North Carolina. At March 31, 2005, the majority of the total loan portfolio was to borrowers within this region. The diversity of the region's economic base provides a stable lending



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environment. No areas of significant concentrations of credit risk have been identified due to the diverse industrial base in the region.

Loans at March 31, 2005 and December 31, 2004 were:

<i>(Dollars in thousands)</i>	<b>March 31, 2005</b>		<b>December 31, 2004</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
Commercial real estate	\$ 774,088	28.6%	\$ 776,474	31.8%
Commercial non real estate	210,990	7.8	212,031	8.7
Construction	347,877	12.9	332,264	13.6
Mortgage	582,893	21.5	347,606	14.2
Consumer	310,690	11.5	304,151	12.5
Home equity	477,884	17.7	467,166	19.2
<b>Total loans</b>	<b>\$ 2,704,422</b>	<b>100.0%</b>	<b>\$ 2,439,692</b>	<b>100.0%</b>

Loans held for sale consist primarily of 15- and 30-year mortgages which the Corporation intends to securitize or sell as whole loans. Loans held for sale are carried at the lower of aggregate cost or market. Loans held for sale were \$6.0 million and \$5.3 million at March 31, 2005 and December 31, 2004, respectively. No valuation allowance to reduce these loans to lower of cost or market was required at March 31, 2005 or December 31, 2004.

The following is a summary of the changes in the allowance for loan losses for the three months ended March 31, 2005 and 2004:

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>	
	<b>March 31, 2005</b>	<b>2004</b>
<b>Balance, beginning of period</b>	<b>\$ 26,872</b>	<b>\$ 25,607</b>
Provision for loan losses	<b>1,900</b>	3,000
Allowance related to loans sold		(549)
Charge-offs	<b>(1,918)</b>	(2,582)
Recoveries	<b>629</b>	260
Net charge-offs	<b>(1,289)</b>	(2,322)
<b>Balance, March 31</b>	<b>\$ 27,483</b>	<b>\$ 25,736</b>

The table below summarizes the Corporation's nonperforming assets and loans 90 days or more past due and still accruing interest at the dates indicated.

<i>(Dollars in thousands)</i>	<b>March 31 2005</b>	December 31 2004
Nonaccrual loans	\$ 9,282	\$ 13,970
Other real estate owned	7,648	3,844
<b>Total nonperforming assets</b>	<b>16,930</b>	17,814
Loans 90 days or more past due and still accruing		
<b>Total nonperforming assets and loans 90 days or more past due and still accruing</b>	<b>\$ 16,930</b>	\$ 17,814

The recorded investment in individually impaired loans was \$4.0 million (all of which were on nonaccrual status) and \$7.7 million (all of which were on nonaccrual status) at March 31, 2005 and December 31, 2004, respectively. The related allowance for loan losses on these loans was \$1.3 million and \$2.1 million at March 31, 2005 and December 31, 2004, respectively. The average recorded investment in individually impaired loans for the three months ended March 31, 2005 and 2004 was \$5.5 million and \$5.0 million, respectively.

**Table of Contents****Note Nine Stock-Based Compensation**

The Corporation accounts for stock-based compensation under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. The following table presents the Corporation's net income and earnings per share as reported, and proforma net income and proforma earnings per share assuming compensation cost for the Corporation's stock option plans had been determined based on the fair value at the grant dates for awards under those plans granted, pursuant to the provisions of the Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation.

<i>(Dollars in thousands, except per share data)</i>	Three Months Ended March 31,	
	2005	2004
Net income, as reported	\$ <b>10,309</b>	\$ 9,240
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(595)	(483)
Pro forma net income	\$ <b>9,714</b>	\$ 8,757
Earnings per share:		
Basic-as reported	\$ <b>0.34</b>	\$ 0.31
Basic-pro forma	\$ <b>0.32</b>	\$ 0.29
Diluted-as reported	\$ <b>0.34</b>	\$ 0.31
Diluted-pro forma	\$ <b>0.32</b>	\$ 0.29

**Note Ten Commitments, Contingencies and Off-Balance Sheet Risk**

*Commitments and Off-Balance Sheet Risk.* The Corporation is party to various financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated financial statements. Commitments to extend credit are agreements to lend to a customer so long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions. Standby letters of credit are recorded as a liability by the Corporation at the fair value of the obligation undertaken in issuing the guarantee. The fair value and carrying value at March 31, 2005 of standby letters of credit issued or modified during the three months ended March 31, 2005 was immaterial. Commitments to extend credit are not recorded as an asset or liability by the Corporation until the instrument is exercised. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for instruments reflected in the consolidated financial statements. The creditworthiness of each customer is evaluated on a case-by-case basis.

At March 31, 2005, the Corporation's exposure to credit risk was represented by preapproved but unused lines of credit totaling \$386.9 million, loan commitments totaling \$495.0 million and standby letters of credit in an aggregate amount of \$9.3 million. Of the \$386.9 million of preapproved unused lines of credit, \$28.0 million were at fixed rates and \$358.9 million were at floating rates. Of the \$495.0 million of loan commitments, \$121.0 million were at fixed rates and \$374.0 million were at floating rates. Of the \$9.3 million of standby letters of credit, \$9.1 million expire in less than one year and \$0.2 million expire in one to three years. The maximum amount of credit loss of standby letters of credit is represented by the contract amount of the instruments. Management expects that these commitments can be funded through normal operations. The amount of collateral obtained if deemed necessary by the Corporation upon extension of

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credit is based on management's credit evaluation of the borrower at that time. The Corporation generally extends credit on a secured basis. Collateral obtained may include, but is not limited to, accounts receivable, inventory and commercial and residential real estate.

The Bank primarily makes commercial and installment loans to customers throughout its market area. The Corporation's primary market area includes the state of North Carolina, and predominately centers on the Metro region of Charlotte, North Carolina. The real estate loan portfolio can be affected by the condition of the local real estate markets.

*Contingencies.* The Corporation and the Bank are defendants in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated operations, liquidity or financial position of the Corporation or the Bank.

During the third quarter of 2004, the Corporation received a proposed income tax assessment from the North Carolina Department of Revenue for the 1999 and 2000 tax years. As a result of this assessment, the Corporation increased its tax reserves by \$818 thousand during 2004. The Corporation's maximum exposure related to this assessment in excess of the current reserve is approximately \$1.5 million, net of tax. The Corporation may also have similar exposure related to its 2001-2004 state tax filings. The Corporation is in the process of appealing this assessment. The Corporation believes it has substantial authority for its reporting and believes that the ultimate outcome will not result in an adverse impact to its results of operations. The Corporation will re-evaluate the adequacy of this reserve as new information or circumstances warrant.

## **Note Eleven Related Party Transactions**

In the ordinary course of business, the Corporation engages in business transactions with certain of its directors. Such transactions are competitively negotiated at arms-length by the Corporation and are not considered to include terms which are unfavorable to the Corporation.

During 2001, the Corporation implemented an automatic overdraft product, which allows customers the ability to overdraw their account and have their transactions honored for a fee. During the fourth quarter of 2001, the Corporation engaged Impact Financial Services ( Impact ) to provide this product. Impact received a fee from the Corporation equal to 15 percent of the incremental income from this new product for a twenty four-month period commencing the fourth full month after the Corporation began to offer the product. John Godbold, a director of the Corporation, is the president and owner of Godbold Financial Associates, Inc. ( GFA ), which acts as an independent sales representative for Impact for Maryland, North Carolina, South Carolina and Virginia, and as such GFA and Mr. Godbold received commissions from Impact based on fees earned by Impact. Management believes that the transaction was at arms-length. Pursuant to the Corporation's conflict of interest policy for directors and executive officers, the members of the Corporation's Board of Directors who did not have a direct or indirect interest in the related party transaction reviewed this related party transaction and determined that it was fair to the Corporation and subsequently approved and ratified the transaction. As described above, no fees were required to be paid to Impact until the fourth full month following introduction of the new product, therefore, no fees were payable to Impact and no commissions were payable to GFA and Mr. Godbold until March 2002. This arrangement terminated on March 31, 2004. For the three months ended March 31, 2004, the Corporation received revenues of approximately \$1.1 million, which resulted in fees of \$164 thousand to Impact and resulted in Impact paying commissions to GFA (and Mr. Godbold) of \$115 thousand.

During the third quarter of 2004, the Corporation entered into a three-year contract pertaining to a software licensing agreement and regulatory compliance guarantee with Impact. The aggregate cost for the three-year period is

\$76 thousand. Mr. Godbold has a 50 percent financial interest in this transaction. Pursuant to the Corporation's conflict of interest policy for directors and executive officers, the members of the Corporation's Board of Directors who did not have a direct or indirect interest in the related party transaction reviewed this related party transaction and determined that it was fair to the Corporation and subsequently approved the transaction.

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**Note Twelve Subsequent Event**

On April 27, 2005 the Corporation modified a legacy short-term disability employee benefit plan. As a result, the Corporation will take a charge to earnings in the second quarter of 2005 of up to \$1.1 million to provide for anticipated obligations related to this modification of the legacy plan.

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Factors that May Affect Future Results**

The following discussion contains certain forward-looking statements about the Corporation's financial condition and results of operations, which are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's judgment only as of the date hereof. The Corporation undertakes no obligation to publicly revise these forward-looking statements to reflect events and circumstances that arise after the date hereof.

Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following possibilities: (1) projected results in connection with the implementation of the Corporation's business plan and strategic initiatives are lower than expected; (2) competitive pressure among financial services companies increases significantly; (3) costs or difficulties related to the integration of acquisitions or expenses in general are greater than expected; (4) general economic conditions, in the markets in which the Corporation does business, are less favorable than expected; (5) risks inherent in making loans, including repayment risks and risks associated with collateral values, are greater than expected; (6) changes in the interest rate environment reduce interest margins and affect funding sources; (7) changes in market rates and prices may adversely affect the value of financial products; (8) legislation or regulatory requirements or changes thereto adversely affect the businesses in which the Corporation is engaged; (9) regulatory compliance cost increases are greater than expected; and (10) the passage of future tax legislation, or any negative regulatory, administrative or judicial position, may adversely impact the Corporation.

**Overview**

The Corporation is a bank holding company established as a North Carolina Corporation in 1983, with one wholly-owned banking subsidiary, the Bank. The Corporation's principal executive offices are located in Charlotte, North Carolina. The Bank is a full service bank and trust company with 53 financial centers and seven insurance offices located in 18 counties throughout the piedmont and western half of North Carolina. The Corporation also maintains operations in Raleigh, NC and Reston, Virginia for the origination of real estate loans. The operation in Reston, Virginia also serves as a holding company for certain subsidiaries that own real estate and real estate-related assets, including first and second residential mortgage loans.

The Corporation's primary market area is located within North Carolina and predominately centers around the Metro region of Charlotte, North Carolina, including Mecklenburg County and its surrounding counties. Charlotte is the twenty-sixth largest city in the United States and has a diverse economic base. Primary business sectors in the Charlotte Metro region include banking and finance, insurance, manufacturing, health care, transportation, retail, telecommunications, government services and education. The Corporation believes that it is not dependent on any one or a few types of commerce due to the region's diverse economic base. Since the North Carolina economy has historically relied on the manufacturing and transportation sectors, it has been significantly impacted by global competition and rising energy prices. As a result, the North Carolina economy is transitioning to a more service-oriented economy. Recently, the education, healthcare, information technology, finance and business services industries have shown the most growth. The unemployment rate for the Charlotte Metro region was 5.1 percent in March 2005 compared to 6.6 percent in March 2004. This decrease is the result of structural changes taking place in



the economy of the region. The service industry is now the major employer in the Charlotte Metro region, followed by wholesale and retail trade.

The Corporation's operations are divided into five primary lines of business: community banking, mortgage, brokerage, insurance, and financial management. Community banking provides a variety of depository accounts including interest-bearing and noninterest-bearing checking accounts, certificates of deposit and money market accounts. In addition, community banking offers numerous loan products

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including commercial, consumer, real estate and home equity loans. The community bank also maintains 110 ATM s and enables customers to access their accounts on-line. The mortgage business provides both fixed-rate and variable-rate mortgage products and loan servicing pursuant to a third party arrangement. First Charter Brokerage Services offers full service and discount brokerage services, annuity sales and financial planning services pursuant to a third party arrangement with UVEST Investment Services. First Charter Insurance Services, Inc. is a North Carolina corporation formed to meet the insurance needs of businesses and individuals throughout the Charlotte Metro region. Financial management provides comprehensive financial planning, funds management, investments and record keeping services for many national companies.

The Corporation derives interest income through traditional banking activities such as generating loans and earning interest on securities. Additional sources of income are derived from fees on deposit accounts and from the Corporation s various lines of business including mortgage, brokerage, insurance and financial management. Also, as a part of the Corporation s management of its securities portfolio, income is recognized on the sale of bond and equity securities.

Loan growth is a major focus of the Corporation. The lending environment continues to be highly competitive. However, the loan portfolio has shown steady growth during the first quarter of 2005 in home equity, mortgage, construction, and consumer loans. Management believes the Corporation is positioned for future loan growth due to an improving market for commercial loans, an increased number of commercial loan officers and an increased focus on small business loans.

In addition, as part of its growth strategy, the Bank entered the Raleigh market by opening a loan production office in the first quarter of 2005 and introducing teams to originate mortgage and construction loans to individuals and residential builders. In addition, the Corporation anticipates offering consumer loans in the Raleigh market later this year.

During the first quarter of 2005, the Corporation purchased \$215.5 million of adjustable-rate mortgage ( ARM ) loans. This purchase was executed under a previously disclosed strategy in which the sale of investment securities and portfolio cash flows would fund the ARM purchases.

The Corporation continues its focus on reducing funding costs through its strategy of growing deposit balances and shifting funding sources from higher-cost retail certificates of deposit to lower-cost, transaction-based accounts, including noninterest bearing deposit, savings, money market and demand deposit accounts. The Corporation s Checking Account Marketing Program ( CHAMP ) continues to attract new customers and deposits. This program is designed to develop new customer relationships, shift the Corporation s funding mix towards lower-cost funding sources and generate additional fee income opportunities.

Maintaining sound asset quality is another major focus for the Corporation. As a result of this focus, the Corporation s asset quality ratios have improved significantly and remain solid. Nevertheless, the business of lending to commercial and consumer customers carries with it significant credit risk, which must be continually managed. Management monitors asset quality and credit risk on an ongoing basis.

The Corporation is also focused on retaining existing customers and attracting new customers. The Corporation s primary methods of competition are to provide exceptional customer service and to proactively market its products. The Corporation conducts a quarterly independent survey of customers to review its level of customer service. During the first quarter of 2005, 85 percent of the customers surveyed reported that they were very satisfied with the service at the Bank, compared to the industry average of 58 percent. To meet the convenience needs of existing and potential customers, the Corporation opened one de novo branch and upgraded two existing branches during 2004, recently introduced extended hours in select branches and its call center and added bilingual personnel. The Corporation will

continue to update existing branches and expand into new markets as both market and economic conditions warrant. At this time, one de novo branch and three branch upgrades are in process, with the expectation that all of these will be completed by December 31, 2005.

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Another focus for the Corporation is growing fee income through complementary lines of business. These business lines diversify the Corporation's earnings with minimal credit risk. The Corporation, through a subsidiary of the Bank, acquired an insurance agency during the fourth quarter of 2004. This acquisition expanded the reach of the Corporation's insurance services with businesses and individuals throughout the Charlotte Metro region. As a result of this acquisition and the continued success of CHAMP, income from service charges and insurance services increased from the first quarter of 2004. The Corporation continuously reviews other opportunities for new products, new services and expansion as conditions warrant.

Competitive pricing pressure on both sides of the balance sheet has mitigated the asset-sensitive nature of the Corporation's balance sheet resulting in a compression of the margin. In addition, a flattening of the yield curve has added additional margin pressure.

The Corporation competes against other banks, savings and loan associations, savings banks, credit unions, finance companies and major retail stores that offer competing financial services. Several larger competitors have different resources, broader geographic coverage and higher lending limits than the Corporation. The Corporation has the fourth largest deposit market share in the Charlotte Metro region, which gives the Corporation greater opportunity to attract new customers and increase its market share.

**Financial Overview**

Net income was \$10.3 million, or \$0.34 per diluted share, for the three months ended March 31, 2005, an increase from net income of \$9.2 million, or \$0.31 per diluted share, for the same period in 2004. First quarter 2005 earnings included \$1.0 million of pre-tax expenses associated with the previously reported separation agreement entered into with the Corporation's former CFO in connection with his retirement from the Corporation.

The annualized return on average assets and common shareholders equity was 0.94 percent and 13.2 percent in for the three months ended March 31, 2005, respectively, compared to 0.88 percent and 12.2 percent for the same period in 2004.

Net interest income was \$30.6 million during the three months ended March 31, 2005 compared to \$30.4 million for the three months ended March 31, 2004, representing a 1 percent increase. A primary driver of this increase was an increase in loan volume, including the previously discussed ARM purchases. The provision for loan losses was \$1.9 million for the three months ended March 31, 2005 compared to \$3.0 million for the same period a year ago. The decrease was primarily due to improved credit quality trends, including lower net charge-offs. For the three months ended March 31, 2005, noninterest income increased \$1.1 million, or 8 percent, to \$15.8 million primarily due to increases in service charges, other miscellaneous fees, and insurance service income. Noninterest expense increased \$0.6 million, or 2 percent, to \$28.9 million primarily due to the aforementioned separation agreement and increased data processing expense.

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	<b>For the Three Months Ended March 31</b>	
	<b>2005</b>	<b>2004</b>
<i>(Dollars in thousands, except per share amounts)</i>		
<b>Income statement</b>		
Interest income	\$ 51,282	\$ 45,230
Interest expense	20,708	14,857
Net interest income	30,574	30,373
Provision for loan losses	1,900	3,000
Noninterest income	15,814	14,665
Noninterest expense	28,869	28,308
Income before income taxes	15,619	13,730
Income taxes	5,310	4,490
Net income	\$ 10,309	\$ 9,240
<b>Per common share</b>		
Basic net income	\$ 0.34	\$ 0.31
Diluted net income	0.34	0.31
Cash dividends declared	0.190	0.185
Period-end book value	10.31	10.38
Average shares outstanding basic	30,234,683	29,738,553
Average shares outstanding diluted	30,630,601	30,029,056
<b>Ratios</b>		
Return on average shareholders' equity <sup>(1)</sup>	13.21%	12.24%
Return on average assets <sup>(1)</sup>	0.94	0.88
Net interest margin <sup>(1)(2)</sup>	3.06	3.19
Average loans to average deposits	97.04	93.31
Average equity to average assets	7.13	7.21
Efficiency ratio <sup>(2)(3)</sup>	61.41	62.56
Dividend payout	56.45	59.68
<b>Selected period end balances</b>		
Securities available for sale	\$ 1,440,494	\$ 1,622,967
Loans, net	2,676,707	2,254,130
Allowance for loan losses	27,483	25,736
Total assets	4,513,053	4,247,861
Total deposits	2,702,708	2,507,442
Borrowings	1,451,756	1,377,374
Total liabilities	4,200,799	3,939,124
Total shareholders' equity	312,254	308,737
<b>Selected average balances</b>		
Loans, net	2,551,876	2,273,575

Earning assets	<b>4,122,175</b>	3,884,954
Total assets	<b>4,439,768</b>	4,210,401
Total deposits	<b>2,629,795</b>	2,436,673
Borrowings	<b>1,443,909</b>	1,430,127
Total shareholders' equity	<b>316,476</b>	303,722

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(1) *Annualized*

(2) *Amounts in 2004 have been adjusted to correct a calculation error with respect to the taxable-equivalent adjustment.*

(3) *Noninterest expense divided by the sum of taxable equivalent net interest income plus noninterest income less gain on sale of securities.*

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### **Critical Accounting Estimates and Policies**

The Corporation's significant accounting policies are described in Note One of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2004, on pages 56 to 65, and are essential in understanding management's discussion and analysis of financial condition and results of operations. Some of the Corporation's accounting policies require significant judgment to estimate values of either assets or liabilities. In addition, certain accounting principles require significant judgment in applying the complex accounting principles to complicated transactions to determine the most appropriate treatment.

The Corporation has identified three accounting policies as being critical in terms of judgments and the extent to which estimates are used: allowance for loan losses, tax contingencies and derivative instruments. In many cases, there are numerous alternative judgments that could be used in the process of estimating values of assets or liabilities. Where alternatives exist, the Corporation has used the factors that we believe represent the most reasonable value in developing the inputs for the valuation. Actual performance that differs from the Corporation's estimates of the key variables could impact net income. For more information on our critical accounting policies, please refer to pages 19 to 21 of our Annual Report on Form 10-K for the year ended December 31, 2004.

### **Earnings Performance**

#### **Net Interest Income and Margin**

Net interest income, the difference between total interest income and total interest expense, is the Corporation's principal source of earnings. An analysis of the Corporation's net interest income on a taxable-equivalent basis and average balance sheets for the three months ended March 31, 2005 and 2004 is presented in **Table Two**. Net interest income on a taxable-equivalent basis ( FTE ) is a non-GAAP (Generally Accepted Accounting Principles) performance measure used by management in operating the business which management believes provides investors with a more accurate picture of the interest margin for comparative purposes. The changes in net interest income (on a taxable-equivalent basis) for the three months ended March 31, 2005 and 2004 are analyzed in **Table Three**. The discussion below is based on net interest income computed under accounting principles generally accepted in the United States of America.

For the three months ended March 31, 2005, net interest income amounted to \$30.6 million, an increase of approximately 1 percent from net interest income of \$30.4 million for the three months ended March 31, 2004. The increase was primarily due to an increase in average earning assets, specifically in loans as a result of strong loan growth. This was partially offset by a more rapid increase in rates paid on interest bearing liabilities than asset yields.

The net interest margin (tax-adjusted net interest income divided by average interest-earning assets) decreased 13 basis points to 3.06 percent for the three months ended March 31, 2005, compared to 3.19 percent in the same 2004 period. The net interest margin was negatively impacted by a 56 basis point increase in the cost of interest bearing liabilities. Partially offsetting this increase was a 35 basis point increase in earning asset yields for the three months ended March 31, 2005 as compared to the same 2004 period.

The cost of interest bearing liabilities during the first quarter of 2005, was impacted by a 93 basis point increase in other borrowing costs and a 34 basis point increase in deposit yields compared to the same 2004 time period. Average interest-bearing liabilities increased \$165.5 million compared to March 31, 2004. The increase was primarily due to a \$151.8 million increase in interest-bearing deposits compared to March 31, 2004, as average retail certificates of

deposits increased \$83.8 million and average wholesale deposits increased \$50.0 million. In addition, average other borrowings increased \$13.9 million.

The yields on earning assets were impacted by an increase of 62 basis points in the yields on loans, and a decrease of 21 basis points in the yields on securities-available-for-sale, for the first quarter of 2005 compared to 2004. Average interest earning assets increased \$237.2 million to \$4.12 billion at March 31,



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2005 compared to \$3.88 billion for the same 2004 period. These increases were primarily due to growth in the Corporation's average loans and loans held for sale portfolio, which increased \$278.3 million, compared to March 31, 2004. A portion of the increase in loans was due to the purchase of ARM loans during the first quarter, which increased average loans and loans held for sale \$106.8 million. This purchase was executed under a previously disclosed strategy in which the sale of investment securities and portfolio cash flows would fund the ARM loan purchases. These ARM loans have similar average lives and a higher yield than the securities sold. These transactions also resulted in a \$29.2 million decrease in the average balance of securities-available-for-sale, compared to March 31, 2004.

The Corporation's primary interest rate risk management objective is to maximize net interest income across a broad range of interest rate scenarios, subject to risk tolerance approval by Management and the Board of Directors.

The following table compares interest income and yields for average interest earning assets and interest expense and rates paid on average interest bearing liabilities for the three months ended March 31, 2005 and 2004. In addition, the table includes the net interest margin.

**Table Two**  
**Average Balances and Net Interest Income Analysis**

	First Quarter 2005			First Quarter 2004		
	Average Balance	Interest Income Expense	Average Yield/Rate Paid <sup>(5)</sup>	Average Balance	Interest Income Expense <sup>(6)</sup>	Average Yield/Rate Paid <sup>(5) (6)</sup>
<i>(Dollars in thousands)</i>						
<b>Interest earning assets:</b>						
Loans and loans held for sale <sup>(1) (2) (3)</sup>	\$ 2,551,876	\$ 36,499	5.80%	\$ 2,273,575	\$ 29,291	5.18%
Securities taxable <sup>(6)</sup>	1,448,157	13,813	3.82	1,517,439	15,173	4.00
Securities nontaxable <sup>(6)</sup>	112,717	1,493	5.30	72,644	1,257	6.92
Federal funds sold	1,528	9	2.43	1,398	3	0.87
Interest bearing bank deposits	7,897	43	2.20	19,898	44	0.88
Total earning assets <sup>(4) (6)</sup>	4,122,175	51,857	5.08	3,884,954	45,768	4.73
Cash and due from banks	93,505			85,183		
Other assets	224,088			240,264		
<b>Total assets</b>	<b>\$ 4,439,768</b>			<b>\$ 4,210,401</b>		
<b>Interest bearing liabilities:</b>						
Demand deposits	807,835	1,536	0.77	789,150	1,230	0.63
Savings deposits	123,221	70	0.23	120,469	84	0.28
Other time deposits	1,325,878	8,908	2.72	1,195,559	6,811	2.29
Other borrowings	1,443,909	10,194	2.82	1,430,127	6,732	1.89
Total interest bearing liabilities	3,700,843	20,708	2.25	3,535,305	14,857	1.69
Noninterest bearing sources:						

Noninterest bearing deposits	<b>372,861</b>		331,496
Other liabilities	<b>49,588</b>		39,878
Shareholders equity	<b>316,476</b>		303,722
<b>Total liabilities and shareholders equity</b>	<b>\$ 4,439,768</b>		\$ 4,210,401
Net interest spread <sup>(6)</sup>		<b>2.83</b>	3.04
Impact of noninterest bearing sources		<b>0.23</b>	0.15
<b>Net interest income/ yield on earning assets <sup>(6)</sup></b>	<b>\$ 31,149</b>	<b>3.06%</b>	\$ 30,911 3.19%

<sup>(1)</sup> The preceding analysis takes into consideration the principal amount of nonaccruing loans and only income actually collected and recognized on such loans.

<sup>(2)</sup> Average loan balances are shown net of unearned income.

<sup>(3)</sup> Includes loan fees and amortization of deferred loan fees of approximately \$467 and \$671 for the first quarter of 2005 and 2004, respectively.

<sup>(4)</sup> Yields on nontaxable securities and loans are stated on a taxable-equivalent basis, assuming a Federal tax rate of 35 percent, applicable state taxes and TEFRA disallowances for the first quarter of 2005 and 2004. The adjustments made to convert to a taxable-equivalent basis were \$575 and \$538 for the first quarter of 2005 and 2004, respectively.

<sup>(5)</sup> Annualized

<sup>(6)</sup> Amounts in 2004 have been adjusted to correct a calculation error with respect to the taxable-equivalent adjustments.

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The following table presents the changes in net interest income due to changes in average balances and rates between the three months ended March 31, 2005 and the three months ended March 31, 2004.

**Table Three**  
**Volume and Rate Variance Analysis**

(Dollars in thousands)	Three Months Ended			
	March 31, 2005 versus March 31, 2004			
	Increase (Decrease) in Net Interest Income			
	Due to Change in Rate and Volume <sup>(1)</sup>			
	2005			2004
	Income/ Expense	Rate	Volume	Income/ Expense
<b>Interest income:</b>				
Loans and loans held for sale <sup>(2)</sup>	\$ 36,499	\$ 3,426	\$ 3,782	\$ 29,291
Securities taxabl <sup>(3)</sup>	13,813	(683)	(677)	15,173
Securities nontaxabl <sup>(2) (3)</sup>	1,493	(376)	612	1,257
Federal funds sold	9	6		3
Interest bearing bank deposits	43	45	(46)	44
Total interest income	\$ 51,857	\$ 2,418	\$ 3,671	\$ 45,768
<b>Interest expense:</b>				
Demand deposits	\$ 1,536	\$ 274	\$ 32	\$ 1,230
Savings deposits	70	(16)	2	84
Other time deposits	8,908	1,288	809	6,811
Other borrowings	10,194	3,381	81	6,732
Total interest expense	20,708	4,927	924	14,857
Net interest income	\$ 31,149	\$ (2,509)	\$ 2,747	\$ 30,911

<sup>(1)</sup> The changes for each category of income and expense are divided between the portion of change attributable to the variance in rate or volume for that category. The amount of change that cannot be separated is allocated to each variance proportionately.

<sup>(2)</sup> Income on nontaxable securities and loans are stated on a taxable-equivalent basis. Refer to **Table Two** for further details.

<sup>(3)</sup> Amounts in 2004 have been adjusted to correct a calculation error with respect to the taxable-equivalent adjustment.

**Noninterest Income**

The major components of noninterest income are derived from service charges on deposit accounts as well as other banking products and services from the Corporation's various lines of business including brokerage, mortgage,

insurance and financial management. In addition, the Corporation realizes gains and losses from the sale of bond and equity securities and income from its investment in Bank Owned Life Insurance ( BOLI ).

Noninterest income increased \$1.1 million, or 8 percent, to \$15.8 million compared to the same period in 2004. Service charges increased \$0.6 million primarily as a result of the continued success of the CHAMP program, which has resulted in checking account growth. Other noninterest income increased \$0.6 million due, in part, to growth in ATM, debit card and other miscellaneous fees as a result of increased transaction volume from the continued success of the CHAMP program. Insurance services income increased \$0.5 million due, in part, to a recently purchased insurance agency and a \$0.1 million increase in contingency income. These increases were partially offset by a \$0.4 million reduction in gains on sales of securities and a \$0.2 million reduction in gains on the sale of property compared to the first quarter of 2004. For the first quarter of 2005, losses on the sale of securities of \$49 thousand were recognized and gains on the sale of property of \$0.5 million were recognized.

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The following table compares noninterest income for the three months ended March 31, 2005 and 2004.

**Table Four**  
**Noninterest Income**

<i>(Dollars in thousands)</i>	<b>Three Months</b>		<b>Increase/(Decrease)</b>	
	<b>Ended March 31</b>	<b>2004</b>	<b>Amount</b>	<b>Percent</b>
Service charges on deposit accounts	\$ 6,236	\$ 5,605	\$ 631	11.3%
Financial management income	1,580	1,502	78	5.2
(Loss) gain on sale of securities	(49)	326	(375)	(115.0)
Loss from equity method investments	(58)	(224)	166	74.1
Mortgage services income	394	428	(34)	(7.9)
Brokerage services income	802	970	(168)	(17.3)
Insurance services income	3,512	3,031	481	15.9
Bank owned life insurance	827	850	(23)	(2.7)
Gain on sale of property	529	777	(248)	(31.9)
Other	2,041	1,400	641	45.8
<b>Total noninterest income</b>	<b>\$ 15,814</b>	<b>\$ 14,665</b>	<b>\$ 1,149</b>	<b>7.8%</b>

**Noninterest Expense**

Noninterest expense is primarily comprised of operating expenses for the Corporation. The major components are salaries and employee benefits, occupancy and equipment, professional fees and other operating expenses.

Noninterest expense increased \$0.6 million, or 2 percent, to \$28.9 million compared to the same period in 2004. A significant contributor to the increase included the previously mentioned \$1.0 million expense associated with the retirement of the Corporation's former CFO's retirement, which was recognized primarily in salaries and employee benefits. Also, a \$0.2 million charge was incurred in the Corporation's financial management business recognized in other noninterest expense. Data processing expenses increased \$0.5 million due to increased debit card and software maintenance expenses. These increases were partially offset by a \$0.8 million decrease in professional fees primarily due to lower Sarbanes-Oxley Act compliance costs. The first quarter of 2004 included consulting fees related to the initial documentation and testing required by the Sarbanes-Oxley Act. In addition, 2004 professional fees included expenses associated with the sale of higher risk mortgage loans in the first quarter of 2004 that did not recur in 2005.

The efficiency ratio, noninterest expense divided by the sum of taxable equivalent net interest income plus noninterest income less gain on the sale of securities, decreased to 61.4 percent for the three months ended March 31, 2005 compared to 62.6 percent for the three months ended March 31, 2004. Losses on sale of securities of \$49 thousand and gains on sale of securities of \$0.3 million are excluded from this calculation for the three months ended March 31, 2005 and 2004, respectively.

The following table compares noninterest expense for three months ended March 31, 2005 and 2004.

**Table Five**

**Noninterest Expense**

<i>(Dollars in thousands)</i>	<b>Three Months Ended March 31</b>		<b>Increase/(Decrease)</b>	
	<b>2005</b>	<b>2004</b>	<b>Amount</b>	<b>Percent</b>
Salaries and employee benefits	<b>\$ 15,569</b>	\$ 15,023	\$ 546	3.6%
Occupancy and equipment	<b>4,381</b>	4,237	144	3.4
Data processing	<b>1,321</b>	862	459	53.2
Marketing	<b>1,080</b>	1,118	(38)	(3.4)
Postage and supplies	<b>1,208</b>	1,271	(63)	(5.0)
Professional services	<b>1,913</b>	2,712	(799)	(29.5)
Amortization of intangibles	<b>131</b>	118	13	11.0
Telephone	<b>528</b>	494	34	6.9
Other	<b>2,738</b>	2,473	265	10.7
<b>Total noninterest expense</b>	<b>\$ 28,869</b>	\$ 28,308	\$ 561	2.0%

**Table of Contents****Income Tax Expense**

The income tax expense for the first quarter of 2005 was \$5.3 million for an effective tax rate of 34.0 percent, compared to \$4.5 million for an effective tax rate of 32.7 percent for first quarter of 2004. The increase in the effective tax rate for 2005 was due to an increase in taxable income relative to nontaxable adjustments.

**Business Segments**

The Corporation's operations are divided into six operating segments: commercial banking, brokerage, insurance, mortgage, leasing and investments, and financial management. These segments are identified based on the Corporation's organizational structure, and the review by the Corporation's chief operating decision makers of the separate results of operations of each of these operating segments. For purposes of segment reporting, the Corporation has only one reportable segment, the Bank, the Corporation's primary banking subsidiary. The Bank provides businesses and individuals with commercial loans, retail loans, and deposit banking services. Brokerage, insurance, mortgage, leasing and investments, and financial management are reported as Other Operating Segments. Of these segments, the results of operations of the Bank constitute a substantial majority of the consolidated net income, revenues and assets of the Corporation, as set forth in *Note Three* of the consolidated financial statements. Included in Other are revenue, expenses and assets of the parent company and eliminating intercompany transactions.

The following table for the Corporation's reportable business segments compares total income for the three months ended March 31, 2005 and 2004:

**Table Six**  
**Business Segment Net Income (Loss)**

	<b>For the Three Months Ended March 31</b>	
	<b>2005</b>	<b>2004</b>
<i>(Dollars in thousands)</i>		
The Bank	<b>\$ 10,046</b>	\$ 9,014
Other Operating Segments	<b>456</b>	307
Other	<b>(193)</b>	(81)
Total consolidated	<b>\$ 10,309</b>	\$ 9,240

The Bank's net income was \$10.0 million for the three months ended March 31, 2005 compared to \$9.0 million for the same 2004 period. Net interest income totaled \$30.4 million during the three months ended March 31, 2005 compared to \$30.5 million for the three months ended March 31, 2004. Increased loan volume was offset by higher funding costs. The provision for loan losses was \$1.9 million for the three months ended March 31, 2005 compared to \$3.0 million for the same period a year ago. The decrease was primarily due to improved credit quality trends. For the three months ended March 31, 2005, noninterest income increased \$1.0 million to \$9.5 million primarily due to increases in service charges and other miscellaneous fees. Noninterest expense increased \$0.1 million to \$22.8 million primarily due to the aforementioned separation agreement and increased data processing expenses.

Other Operating Segments reported net income of \$0.5 million for the three months ending March 31, 2005 compared \$0.3 million for the same year-ago period. Net interest income increased \$0.4 million due to additional purchases of securities by the leasing and investments segment. Noninterest income increased \$0.3 million due to the

following: increases in insurance services revenues resulting from the successful integration of an insurance agency acquired in the fourth quarter of 2004 and an increase in contingency income, and increases in financial management income, partially offset by decreased brokerage services income and mortgage services income. Noninterest expense increased \$0.5 million resulting from a one-time charge incurred in the Corporation's financial management business and an increase in salaries and employee benefits due to increased incentives and additional personnel, including the acquisition of an insurance agency.



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Other reported a net loss of \$193 thousand for the three months ended March 31, 2005 compared to \$81 thousand for the same 2004 period. The first quarter of 2004 included gains on the sale of equity securities of \$131 thousand, which did not recur in 2005.

## **Balance Sheet Analysis**

### **Securities-Available-for-Sale**

The securities portfolio, all of which is classified as available-for-sale, is a component of the Corporation's Asset Liability Management (ALM) strategy. The decision to purchase or sell securities is based upon liquidity needs, changes in interest rates, changes in prepayment risk, and other factors. Securities-available-for-sale are accounted for at fair value, with unrealized gains and losses recorded net of tax as a component of other comprehensive income in shareholders' equity.

The fair value of the securities portfolio is determined by a third party. The valuation is determined as of a date within close proximity to the end of the reporting period based on available quoted market prices or quoted market prices for similar securities if a quoted market price is not available.

At March 31, 2005, securities-available-for-sale were \$1.44 billion or 32 percent of total assets, compared to \$1.65 billion or 37 percent of total assets at December 31, 2004. The decrease was primarily due to the sale of securities, which together with cash flows from the portfolio were used to fund the purchase of whole mortgage loans. The securities-available-for-sale portfolio also was impacted by an increase in the pre-tax unrealized net losses in the portfolio due to a rise in short and intermediate-term interest rates. Pre-tax unrealized net losses on securities-available-for-sale were \$26.0 million at March 31, 2005 compared to \$8.0 million at December 31, 2004.

Proceeds from the sale of securities-available-for-sale were \$157.9 million and \$20.3 million for the three months ended March 31, 2005 and 2004, respectively. Gross gains of \$1.2 million and gross losses of \$1.3 million were realized in the first quarter of 2005, compared to gross gains of \$0.7 million and gross losses of \$0.4 million realized in the first quarter of 2004. The weighted average life of the portfolio was 3.91 years at March 31, 2005 compared to 3.84 years at December 31, 2004. With market indicators predicting a continued rise in interest rates, the unrealized net losses in the securities-available-for-sale portfolio could increase.

### **Loan Portfolio**

The Corporation's loan portfolio at March 31, 2005 consisted of six major categories: Commercial Non Real Estate, Commercial Real Estate, Construction, Mortgage, Consumer, and Home Equity. Within these six segments the Corporation targets customers in its geographic area, works within most business segments and focuses on a relationship-based business model. Pricing is driven by quality, loan size, the Corporation's relationship with the customer and by competition. The Corporation is primarily a secured lender in all of these loan categories. The terms of the Corporation's loans are generally five years or less with the exception of home equity lines and residential mortgages, for which the terms range from 15 to 30 years. In addition, the Corporation has a program in which it buys and sells portions of loans (primarily originated in the Southeastern region of the United States), both participations and syndications, from key strategic partner financial institutions with which the Corporation has established relationships. At March 31, 2005, current balances of the loans purchased and sold through the strategic partners program were \$259.6 million and \$22.2 million, respectively. This portfolio includes commercial real estate, commercial non real estate and construction loans. This program enables the Corporation to diversify both its geographic and its total exposure risk.

*Commercial Non Real Estate*

The Corporation's commercial non real estate lending program is generally targeted to serve small-to-middle market businesses with sales of \$50 million or less in the Corporation's geographic area. Commercial lending includes commercial, financial, agricultural and industrial loans. Pricing on commercial non real estate loans, driven largely by the Corporation's relationship with the customer and

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by competition, is usually tied to widely recognized market indexes, such as the prime rate, the London Interbank Offer Rate ( LIBOR ) or rates on U.S. Treasury securities.

### *Commercial Real Estate*

Similar to commercial non real estate lending, the Corporation's commercial real estate lending program is generally targeted to serve small-to-middle market business with sales of \$50 million or less in the Corporation's geographic area. The real estate loans are both owner occupied and project related. As with commercial non real estate loans, pricing on commercial real estate loans, driven largely by the Corporation's relationship with the customer and by competition, is usually tied to widely recognized market indexes, such as the prime rate, LIBOR or rates on U.S. Treasury securities.

### *Construction*

Real estate construction loans include both commercial and residential construction/permanent loans, which are intended to convert to permanent loans upon completion of the construction project. Loans for commercial construction are usually to in-market developers, builders, businesses, individuals or real estate investors for the construction of commercial structures primarily in the Corporation's market area. From time to time, the Corporation purchases construction loans in other market areas through a correspondent relationship. At March 31, 2005, loans purchased through this relationship represented 26 percent of the total construction loan portfolio. Construction loans purchased are typically serviced by third parties. Loans are made for purposes including, but not limited to, the construction of industrial facilities, apartments, shopping centers, office buildings, homes and warehouses. The properties may be constructed for sale, lease or owner-occupancy.

### *Mortgage*

The Corporation originates 1-4 family residential mortgage loans throughout the Corporation's footprint and in loan origination offices in Reston, Virginia and Raleigh, North Carolina. From time to time, the Corporation purchases ARM loans in other market areas through a correspondent relationship. The Corporation offers a full line of products, including conventional, conforming, and jumbo fixed rate and adjustable rate mortgages which are originated and securitized or sold into the secondary market; however, from time to time a portion of this production is retained and serviced through a third party arrangement.

### *Consumer*

The Corporation offers a wide variety of consumer loan products. Various types of secured and unsecured loans are marketed to qualifying existing customers and to other creditworthy candidates in the Corporation's market area. Unsecured loans, including revolving credits (e.g. checking account overdraft protection and personal lines of credit) are provided and various installment loan products such as vehicle loans are offered.

### *Home Equity*

Home Equity loans and lines are secured by first and second liens on the borrower's residential real estate. As with all consumer lending, home equity loans are centrally decisioned and documented to ensure the underwriting conforms to the corporate lending policy.

Gross loans increased \$264.7 million, or 11 percent, to \$2.70 billion at March 31, 2005 compared to \$2.44 billion at December 31, 2004. The growth in loans was primarily due to (i) a \$235.3 million increase in mortgage loans, of which \$215.5 million was attributable to the purchase of ARM loans during the quarter, (ii) a \$15.6 million increase in

construction loans, (iii) a \$10.7 million increase in home equity loans and (iv) a \$6.5 million increase in consumer loans. These increases were partially offset by a \$2.4 million and \$1.0 million decrease in commercial real estate and commercial non real estate loans, respectively.

The mix of variable-rate, adjustable-rate and fixed-rate loans is incorporated in the Corporation's ALM strategy. As of March 31, 2005, of the \$2.70 billion loan portfolio, approximately \$1.57 billion was tied to variable interest rates, most of which reprice within one day of any interest rate change; approximately \$0.62 billion was tied to fixed interest rates with scheduled maturities and \$0.50 billion was tied to adjustable interest rates, which are ARM loans and reprice on a fixed schedule.

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The table below summarizes loans in the classifications indicated as of March 31, 2005 and December 31, 2004.

**Table Seven**  
**Loan Portfolio Composition**

<i>(Dollars in thousands)</i>	<b>March 31,</b>	%	December	%
	<b>2005</b>	of Total	31,	of Total
		Loans	2004	Loans
Commercial real estate	\$ 774,088	28.6%	\$ 776,474	31.8%
Commercial non real estate	210,990	7.8	212,031	8.7
Construction	347,877	12.9	332,264	13.6
Mortgage	582,893	21.5	347,606	14.2
Consumer	310,690	11.5	304,151	12.5
Home equity	477,884	17.7	467,166	19.2
<b>Total loans</b>	<b>2,704,422</b>	<b>100.0</b>	<b>2,439,692</b>	<b>100.0</b>
Less allowance for loan losses	(27,483)	(1.0)	(26,872)	(1.1)
Unearned income	(232)	(0.0)	(291)	(0.0)
<b>Loans, net</b>	<b>\$ 2,676,707</b>	<b>99.0%</b>	<b>\$ 2,412,529</b>	<b>98.9%</b>

**Deposits**

The Corporation's CHAMP continues to attract new customers and deposits. During the first quarter of 2005, 11,392 new checking accounts were opened. This program is designed to develop new customer relationships, shift the Corporation's funding mix towards lower-cost funding sources and generate additional fee income opportunities.

Total deposits increased \$92.9 million, or 4 percent, to \$2.70 billion at March 31, 2005 compared to \$2.61 billion at December 31, 2004. Valuable transaction deposits (defined as interest checking, savings, noninterest bearing deposits and money market accounts) increased \$6.5 million, which included a \$25.2 million increase in noninterest bearing deposits. Certificates of deposit (CDs) also grew \$86.3 million, with an \$83.0 million increase in brokered CDs and a \$3.3 million increase in retail CDs. **Table Two** provides information on the average deposit balances for the three months ended March 31, 2005 and 2004.

**Other Borrowings**

Other borrowings consist of Federal Funds purchased, securities sold under agreement to repurchase, FHLB borrowings and other miscellaneous borrowings. Securities sold under agreements to repurchase represent short-term borrowings by the Bank collateralized by a portion of the Corporation's securities portfolio. These borrowings are an important source of funding to the Corporation. Access to alternate short-term funding sources allows the Corporation to meet funding needs without relying on increasing deposits on a short-term basis. FHLB borrowings are collateralized by securities from the Corporation's investment portfolio and a blanket lien on certain qualifying commercial and single family loans held in the Corporation's loan portfolio. FHLB borrowings are an alternative to

other funding sources with similar maturities. Other borrowings increased \$2.0 million during the first quarter, to \$1.45 billion at March 31, 2005, compared to December 31, 2004.

### **Credit Risk Management**

The Corporation's credit risk policy and procedures are centralized for every loan type. In addition, all mortgage, consumer and home equity loans are centrally decided. All loans flow through an independent closing unit to ensure proper documentation. Finally, all known collection or problem loans are centrally managed by experienced workout personnel. To monitor the effectiveness of policies and procedures, Management maintains a set of asset quality standards for past due, nonaccrual and watch

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list loans and monitors the trends of these standards over time. These standards are approved by the Board of Directors and reviewed quarterly with the Board of Directors for compliance.

### **Loan Administration and Underwriting**

The Bank's Chief Risk Officer is responsible for the continuous assessment of the Bank's risk profile as well as making any necessary adjustments to policies and procedures. Commercial loan relationships less than \$750 thousand may be approved by experienced commercial loan officers, within their loan authority. Commercial and commercial real estate loans are approved by signature authority requiring at least two experienced officers for relationships greater than \$750 thousand. The exceptions to this would include City Executives (senior loan officers) who are authorized to approve relationships up to \$1.0 million and the Bank's Strategic Partners Division, whose manager has \$1.5 million of loan authority for such relationships. An independent Risk Manager is involved in the approval of commercial and commercial real estate relationships that exceed \$1.0 million and Strategic Partner relationships that exceed \$1.5 million. All relationships greater than \$2.0 million receive a comprehensive annual review by either the senior credit analysts or lending officers of the Bank, which is then reviewed by the independent Risk Managers and/or the final approval officer with the appropriate signature authority. Commitments over \$5.0 million are further reviewed by senior lending officers of the Bank, the Chief Risk Officer and the Lending Oversight Committee comprised of executive and senior management. In addition, commitments over \$10.0 million are reviewed by the Board of Directors Loan Committee. These oversight committees provide policy, process, product and specific relationship direction to the lending personnel. The Corporation has a general target lending limit of \$10.0 million per relationship; however, at times some loan relationships may exceed that limit. As of March 31, 2005, the Corporation had 10 relationships with exposure greater than the \$10.0 million lending limit. At March 31, 2005, the total loan balance of these relationships was \$113.8 million, all of which were current, with unfunded commitments totaling \$57.3 million.

The Corporation's loan portfolio consists of loans made for a variety of commercial and consumer purposes. Because commercial loans are made based to a great extent on the Corporation's assessment of a borrower's income, cash flow, character and ability to repay, such loans are viewed as involving a higher degree of credit risk than is the case with residential mortgage loans or consumer loans. To manage this risk, the Corporation's commercial loan portfolio is managed under a defined process which includes underwriting standards and risk assessment, procedures for loan approvals, loan grading, ongoing identification and management of credit deterioration and portfolio reviews to assess loss exposure and to ascertain compliance with the Corporation's credit policies and procedures.

In general, consumer loans (including mortgage and home equity) are deemed less risky than commercial loans. Commercial loans (including commercial real estate, commercial non real estate and construction loans) are generally larger in size and more complex than consumer loans. Commercial real estate loans are deemed less risky than commercial non real estate and construction loans, as the collateral value of real estate generally maintains its value better than non real estate or construction collateral. Consumer loans, being smaller in size and more geographically diverse across the Corporation's entire primary market area, provide risk diversity across the portfolio. Because mortgage loans are secured by first liens on the consumer's residential real estate, they are the Corporation's least risky loan type. Home equity loans are deemed less risky than unsecured consumer loans as home equity loans and lines are secured by first or second deeds of trust on the borrower's residential real estate. A centralized decisioning process is in place to control the risk of the consumer, home equity and mortgage loan portfolio. The consumer real estate appraisal process is also centralized relative to appraisal engagement, appraisal review, and appraiser quality assessment. These processes are detailed in the underwriting guidelines, which cover each retail loan product type from underwriting, servicing, compliance issues and closing procedures.

The Corporation's primary market area includes the state of North Carolina but predominately centers around the metro region of Charlotte. At March 31, 2005, the majority of the total loan portfolio, as well as a substantial portion

of the commercial and real estate loan portfolio, represents loans to borrowers within this metro region. An economic downturn in the Corporation's primary market area could adversely affect its business. The diversity of the region's economic base tends to provide a stable lending environment.



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No significant concentration of credit risk has been identified due to the diverse industrial base in the region.

**Derivatives**

Credit risk associated with derivatives is measured as the net replacement cost should the counter-parties with contracts in a gain position to the Corporation completely fail to perform under the terms of those contracts assuming no recoveries of underlying collateral. In managing derivative credit risk, both the current exposure, which is the replacement cost of contracts on the measurement date, as well as an estimate of the potential change in value of contracts over their remaining lives are considered. To minimize credit risk, the Corporation enters into legally enforceable master netting agreements, which reduce risk by permitting the closeout and netting of transactions with the same counter-party upon the occurrence of certain events. In addition, the Corporation reduces risk by obtaining collateral based on individual assessments of the counter-parties to these agreements. The determination of the need for and levels of collateral will vary depending on the credit risk rating of the counter-party. See **Asset-Liability Management and Interest Rate Risk** for further details regarding these interest rate swap agreements.

**Nonperforming Assets**

Nonperforming assets are comprised of nonaccrual loans and other real estate owned ( OREO ). The nonaccrual status is determined after a loan is 90 days past due as to principal or interest, unless in management's opinion collection of both principal and interest is assured by way of collateralization, guarantees or other security and the loan is in the process of collection. OREO represents real estate acquired through foreclosure or deed in lieu thereof and is generally carried at the lower of cost or fair value, less estimated costs to sell.

Nonaccrual loans at March 31, 2005 decreased to \$9.3 million compared to \$14.0 million at December 31, 2004. The decrease includes the transfer of one large relationship totaling \$2.6 million to OREO during the first quarter of 2005. As a result, OREO increased to \$7.6 million at March 31, 2005 from \$3.8 million at December 31, 2004.

As a result of the Corporation's continued focus on asset quality and generally improving economic conditions, asset quality remains strong. The table below summarizes the Corporation's nonperforming assets and loans 90 days or more past due and still accruing interest as of the dates indicated.

**Table Eight**  
**Nonperforming and Problem Assets**

(Dollars in thousands)	<b>March 31 2005</b>	December 31 2004	September 30 2004	June 30 2004	March 31 2004
Nonaccrual loans	\$ 9,282	\$ 13,970	\$ 14,237	\$ 12,533	\$ 11,845
Other real estate owned	7,648	3,844	4,962	6,159	6,199
Total nonperforming assets	<b>16,930</b>	17,814	19,199	18,692	18,044
Loans 90 days or more past due and still accruing interest			56		
	<b>\$ 16,930</b>	\$ 17,814	\$ 19,255	\$ 18,692	\$ 18,044

Total nonperforming assets and loans  
90 days or more past due and still accruing  
interest

Nonperforming assets as a percentage of:

Total assets	<b>0.38%</b>	0.40%	0.44%	0.43%	0.42%
Total loans and other real estate owned	<b>0.62</b>	0.73	0.79	0.79	0.79
Nonaccrual loans as a percentage of loans	<b>0.34</b>	0.57	0.59	0.53	0.52
Ratio of allowance for loan losses to nonperforming loans	<b>2.96x</b>	1.92x	1.89x	2.08x	2.17x

Nonaccrual loans at March 31, 2005 were not concentrated in any one industry and primarily consisted of several large credits secured by real estate. Management anticipates that nonaccrual loans may increase in the near term as some customers continue to experience difficulties in this current economic environment. Management has taken current economic conditions into consideration when

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estimating the allowance for loan losses. See **Allowance for Loan Losses** for a more detailed discussion.

Management's policy for any accruing loan greater than 90 days past due is to perform an analysis of the loan, including a consideration of the financial position of the borrower and any guarantor as well as the value of the collateral, and use this information to make an assessment as to whether collectibility of the principal and interest appears probable. If such collectibility is not probable, the loans are placed on nonaccrual status. Loans are returned to accrual status when management determines, based on an evaluation of the underlying collateral together with the borrower's payment record and financial condition, that the borrower has the ability and intent to meet the contractual obligations of the loan agreement.

### **Allowance for Loan Losses**

The Corporation's allowance for loan losses consists of four components: (i) valuation allowances computed on impaired loans in accordance with SFAS No. 114; (ii) valuation allowance for certain classified loans; (iii) valuation allowances determined by applying historical loss rates to those loans not specifically identified as impaired; and (iv) valuation allowances for factors which management believes are not reflected in the historical loss rates or that otherwise need to be considered when estimating the allowance for loan losses. These four components are estimated quarterly by Credit Risk Management and, along with a narrative analysis, comprise the Corporation's allowance for loan losses model. The resulting components are used by management to determine the adequacy of the allowance for loan losses.

All estimates of loan portfolio risk, including the adequacy of the allowance for loan losses, are subject to general and local economic conditions, among other factors, which are unpredictable and beyond the Corporation's control. Since a significant portion of the loan portfolio is comprised of real estate loans and loans to area businesses, the Corporation is subject to risk in the real estate market and changes in the economic conditions in its primary market area. Changes in these areas can increase or decrease the provision for loan losses.

During the first quarter of 2005, the Corporation made no changes to its estimated loss percentages for economic factors. As a part of its quarterly assessment of the allowance for loan losses, the Corporation reviews key local, regional and national economic information and assesses its impact on the allowance for loan losses. Based on its review for the three months ended March 31, 2005, the Corporation noted that economic conditions are mixed; however, management concluded that the impact on borrowers and local industries in the Corporation's primary market area did not change significantly during the period. Accordingly, the Corporation did not modify its loss estimate percentage attributable to economic factors in its allowance for loan losses model.

The Corporation continuously reviews its portfolio for any concentrations of loans to any one borrower or industry. To analyze its concentrations, the Corporation prepares various reports showing total loans to borrowers by industry, as well as reports showing total loans to one borrower. At the present time, the Corporation does not believe it is overly concentrated to any industry or specific borrower and therefore has made no allocations of allowances for loan losses for this factor for any of the periods presented.

The Corporation also monitors the amount of operational risk that exists in the portfolio. This would include the front-end underwriting, documentation and closing processes associated with the lending decision. The percent of additional allocation for the operational reserve was increased during the first quarter for loans originated using key referral sources, new commercial lenders, and finally the additional collateral risk associated with competitive market forces which are forcing the industry to increase the acceptable loan to value ratios for certain consumer based loans secured by real estate. The Corporation believes these additional risks are adequately provided for in its allowance for loan losses model.



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The table below presents certain data for the three months ended March 31, 2005 and 2004, including the following: (i) the allowance for loan losses at the beginning of the year, (ii) loans charged off and recovered (iii) loan charge-offs, net, (iv) the provision for loan losses, (v) the allowance for loan losses at March 31, 2005 and 2004, (vi) the average amount of net loans outstanding during the quarter, (vii) the ratio of net charge-offs to average loans and (viii) the ratio of the allowance for loan losses to loans at March 31, 2005 and 2004.

**Table Nine**  
**Allowance For Loan Losses**

<i>(Dollars in thousands)</i>	Three Months Ended March 31,	
	2005	2004
<b>Balance, beginning of period</b>	<b>\$ 26,872</b>	<b>\$ 25,607</b>
<b>Loan charge-offs:</b>		
Commercial non real estate	511	265
Commercial real estate	553	1,035
Mortgage	49	29
Consumer	601	855
Home equity	204	398
Total loans charged-off	1,918	2,582
<b>Recoveries of loans previously charged-off:</b>		
Commercial non real estate	439	25
Consumer	190	235
Total recoveries of loans previously charged-off	629	260
Net charge-offs	1,289	2,322
Provision for loan losses	1,900	3,000
Allowance related to loans sold		(549)
<b>Balance, March 31</b>	<b>\$ 27,483</b>	<b>\$ 25,736</b>
Average loans	\$ 2,547,226	\$ 2,271,763
Net charge-offs to average loans (annualized)	0.21%	0.41%
Allowance for loan losses to gross loans	1.02	1.13

The allowance for loan losses was \$27.5 million or 1.02 percent of gross loans at March 31, 2005 compared to \$26.9 million or 1.10 percent of gross loans at December 31, 2004. The allowance for loan losses as a percentage of loans decreased due to improved asset quality trends, as well as a change in the mix of the loan portfolio towards 1-4 family mortgages and home equity lines of credit. This type of secured lending generally carries lower credit risk and

thus requires lower allocations in the Corporation's allowance model. In addition, the allowance for loan losses was reduced by net charge-offs of \$1.3 million. These reductions were offset by an additional provision expense of \$1.9 million for the three months ended March 31, 2005.

The allowance for loan losses was also impacted by changes in the allocation of loan losses to various loan types. Total commercial loan allocations of allowance for loan losses decreased approximately \$0.9 million in the first three months of 2005. Commercial allowance allocations were affected by lower historical loss factors as asset quality trends improved. As the asset quality in the commercial loan portfolio improves, the historical loss factors continue to decrease. Management anticipates these historical loss factors will trend lower over time, as the allowance model will be impacted by lower historical losses. Allocations of allowance for loan losses for consumer loans increased approximately \$0.3 million in the first quarter of 2005 due to consumer loan growth.

Management considers the allowance for loan losses adequate to cover inherent losses in the Bank's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in consideration of the current economic environment. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary based on changes in economic and other conditions. Additionally, various regulatory agencies, as an integral part

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of their examination process, periodically review the Bank's allowances for loan losses. Such agencies may require the recognition of adjustments to the allowances based on their judgments of information available to them at the time of their examinations.

### **Provision for Loan Losses**

The provision for loan losses is the amount charged to earnings which is necessary to maintain an adequate and appropriate allowance for loan losses. Accordingly, the factors which influence changes in the allowance for loan losses have a direct effect on the provision for loan losses. The allowance for loan losses changes from period to period as a result of a number of factors, the most significant of which for the Corporation include the following: (i) changes in the mix of types of loans; (ii) current charge-offs and recoveries of loans; (iii) changes in impaired loan valuation allowances; (iv) changes in valuations in certain performing loans which have specific allocations; (v) changes in credit grades within the portfolio, which arise from a deterioration or an improvement in the performance of the borrower; (vi) changes in historical loss percentages; and (vii) changes in the amounts of loans outstanding, which are used to estimate current probable loan losses. In addition, the Corporation considers other, more subjective factors which impact the credit quality of the portfolio as a whole and estimates allocations of allowance for loan losses for these factors, as well. These factors include loan concentrations, economic conditions and operational risks. Changes in these components of the allowance can arise from fluctuations in the underlying percentages used as related loss estimates for these factors, as well as variations in the portfolio balances to which they are applied. The net change in all of these components of the allowance for loan losses results in the provision for loan losses. For a more detailed discussion of the Corporation's process for estimating the allowance for loan losses, see **Allowance for Loan Losses**.

The provision for loan losses decreased to \$1.9 million for the three months ended March 31, 2005 compared to \$3.0 million for the same year ago period. The decrease in the provision for loan losses was primarily attributable to improved asset quality trends, as well as a change in the mix of the loan portfolio towards 1-4 family mortgages and home equity lines of credit. The provision for loan losses was also impacted by a decrease in net charge-offs of \$1.0 million for the three months ended March 31, 2005, compared to the same year-ago period. Net charge-offs for the three months ended March 31, 2005 amounted to \$1.3 million, or 0.21 percent of average loans, compared to \$2.3 million, or 0.41 percent of average loans for the same 2004 period.

### **Market Risk Management**

#### **Asset-Liability Management and Interest Rate Risk**

The Corporation's primary interest rate risk management objective is to maximize net interest income across a broad range of interest rate scenarios, subject to risk tolerance approval by Management and the Board of Directors. One method used to manage interest rate sensitivity is to measure, over various time periods, the interest rate sensitivity positions, or gaps; however, this method addresses only the magnitude of timing differences and does not address earnings, market value or optionality in the balance sheet. Management uses an earnings simulation model to assess the amount of earnings at risk due to changes in interest rates. Management believes this method more accurately measures interest rate risk. This model is updated monthly and is based on a range of interest rate shock scenarios. Under the Corporation's policy, the limit for interest rate risk is 10 percent of net interest income when considering an increase or decrease in interest rates of 300 basis points over a twelve-month period. Assuming a 300 basis point pro-rata increase in interest rates over a twelve-month period, the Corporation's sensitivity to interest rate risk would positively impact net interest income by approximately 1.8 percent of net interest income at March 31, 2005. Assuming a 200 basis point pro-rata decrease in interest rates over a twelve-month period, the Corporation's

sensitivity to interest rate risk would negatively impact net interest income by approximately 1.3 percent of net interest income at March 31, 2005. Although the Corporation's policy for interest shock scenarios is an increase or decrease of 300 basis points, in the current low interest rate environment rate it believes a 200 basis point decline in rates is more appropriate. Both of the rate shock scenarios are within Management's acceptable range. The Corporation also completes instantaneous parallel interest rate shocks. Assuming a 300 basis point increase in interest rates on April 1, 2005, the Corporation's sensitivity to interest rate risk would negatively impact net interest income by approximately



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1.3 percent of net interest income at March 31, 2005. Assuming a 200 basis point decrease in interest rates at April 1, 2005, the Corporation's sensitivity to interest rate risk would negatively impact net interest income by approximately 4.3 percent of net interest income at March 31, 2005.

During 2004, the Corporation entered into a series of interest rate swap agreements. The interest rate swaps resulted in the Corporation receiving interest at an average fixed-rate of 5.16 percent and paying interest at an average LIBOR-based variable-rate of 4.39 percent, for an average remaining period of 5.0 years with a notional amount of \$222 million.

Interest rate swaps assist the Corporation's ALM process. The Corporation's interest rate risk management strategy includes the use of interest rate contracts to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. The Corporation's goal is to manage interest rate sensitivity so that movements in interest rates do not have significant adverse effects on net interest income. As a result of interest rate fluctuations, hedged fixed-rate liabilities appreciate or depreciate in market value. Gains or losses on the derivative instruments that are linked to the hedged fixed-rate liabilities are expected to substantially offset this unrealized appreciation or depreciation. Exposure to gains or losses on these contracts will change over their respective lives as interest rates fluctuate.

**Table Ten** summarizes the expected maturities and weighted average effective yields and rates associated with certain of the Corporation's significant non-trading financial instruments. Cash and cash equivalents, federal funds sold and interest-bearing bank deposits are excluded from **Table Ten** as their respective carrying values approximate fair values. These financial instruments generally expose the Corporation to insignificant market risk as they have either no stated maturities or an average maturity of less than 30 days and interest rates that approximate market rates. However, these financial instruments could expose the Corporation to interest rate risk by requiring more or less reliance on alternative funding sources, such as long-term debt. The mortgage-backed securities are shown at their weighted average expected life, obtained from an outside evaluation of the average remaining life of each security based on historic prepayment speeds of the underlying mortgages at March 31, 2005. These expected maturities, weighted average effective yields and fair values will change if interest rates change. Demand deposits, money market accounts and certain savings deposits are presented in the earliest maturity window because they have no stated maturity.

**Table of Contents****Table Ten  
Market Risk**

March 31, 2005

<i>(Dollars in thousands)</i>	<b>Total</b>	<b>1 Year</b>	<b>2 Years</b>	<b>Expected Maturity</b>			<b>Thereafter</b>
				<b>3 Years</b>	<b>4 Years</b>	<b>5 Years</b>	
<b>Assets</b>							
Debt securities							
<i>Fixed rate</i>							
Book value	\$ 1,275,481	\$ 172,083	\$ 233,768	\$ 321,077	\$ 418,443	\$ 56,885	\$ 73,225
Weighted average effective yield	3.85%						
Fair value	\$ 1,252,506						
<i>Variable rate</i>							
Book value	\$ 126,590	27,670	27,791	27,947	28,138	15,044	
Weighted average effective yield	3.92%						
Fair value	\$ 123,516						
Loans and loans held for sale							
<i>Fixed rate</i>							
Book value	\$ 615,401	135,906	117,042	96,658	74,006	73,578	118,211
Weighted average effective yield	6.54%						
Fair value	\$ 618,948						
<i>Variable rate</i>							
Book value	\$ 2,067,312	688,661	338,269	251,341	141,167	72,610	575,264
Weighted average effective yield	6.90%						
Fair value	\$ 2,162,818						
<b>Liabilities</b>							
Deposits							
<i>Fixed rate</i>							
Book value	\$ 1,371,789	1,083,188	177,781	99,052	5,754	5,911	103
Weighted average effective yield	2.77%						
Fair value	\$ 1,369,836						
<i>Variable rate</i>							
Book value	\$ 927,933	231,423	232,338	229,971	109,980	58,670	65,551
Weighted average effective yield	0.64%						
Fair value	\$ 890,415						
Other borrowings							
<i>Fixed rate</i>							
Book value	\$ 758,632	215,044	350,054	100,057	59	52,063	41,355

Weighted average effective yield		3.98%	
Fair value	\$	779,943	
<i>Variable rate</i>			
Book value	\$	693,124	693,124
Weighted average effective yield		2.62%	
Fair value	\$	693,094	

### Off-Balance Sheet Risk

The Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit are agreements to lend to a customer so long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions. Standby letters of credit are recorded as a liability by the Corporation at the fair value of the obligation undertaken in issuing the guarantee. Commitments to extend credit are not recorded as an asset or liability by the Corporation until the instrument is exercised. Refer to *Note Twelve* of the consolidated financial statements for further

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discussion of commitments. The Corporation does not have any special purpose entities or off-balance sheet financing arrangements.

The following table presents aggregated information about commitments of the Corporation which could impact future periods.

**Table Eleven****Commitments**

As of March 31, 2005

(Dollars in thousands)	Amount of Commitment Expiration Per Period				Total Amounts Committed
	Less than 1 year	1-3 Years	4-5 Years	Over 5 Years	
Lines of Credit	\$ 28,843	\$ 3,600	\$ 2,268	\$ 352,182	\$ 386,893
Standby Letters of Credit	9,117	140			9,257
Loan Commitments	381,592	76,904	16,087	20,406	494,989
<b>Total Commitments</b>	<b>\$ 419,552</b>	<b>\$ 80,644</b>	<b>\$ 18,355</b>	<b>\$ 372,588</b>	<b>\$ 891,139</b>

**Liquidity Risk**

Liquidity is the ability to maintain cash flows adequate to fund operations and meet obligations and other commitments on a timely and cost-effective basis. Liquidity is provided by the ability to attract retail deposits, by current earnings, and by a strong capital base that enables the Corporation to use alternative funding sources that complement normal sources. Management's asset-liability policy includes optimizing net interest income while continuing to provide adequate liquidity to meet continuing loan demand and deposit withdrawal requirements and to service normal operating expenses.

Liquidity is managed at two levels. The first is the liquidity of the parent company, which is the holding company that owns the Bank. The second is the liquidity of the Bank. The management of liquidity at both levels is essential because the parent company and the Bank each have different funding needs and sources, and each are subject to certain regulatory guidelines and requirements.

The primary source of funding for the parent company include dividends received from the Bank and proceeds from the issuance of equity. In addition the Parent Company had a \$25.0 million line of credit from a third party source with \$11.0 million outstanding and commercial paper outstandings of \$52.2 million at March 31, 2005. Primary uses of funds for the parent company include repayment of commercial paper, share repurchases and dividends paid to shareholders.

Primary sources of funding for the Bank include customer deposits (retail and wholesale), other borrowings, loan repayments and securities available for sale. The Bank has access to federal fund lines at correspondent banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank is a member of the FHLB, which provides access to FHLB lending sources. At March 31, 2005, the Bank had an available line of credit with the FHLB totaling \$1.35 billion with \$1.12 billion outstanding. At March 31, 2005, the Bank also had federal funds back-up lines of credit totaling \$90.0 million with \$16.0 million outstanding. Primary uses of funds include

repayment of maturing obligations and growth in loans.

## Capital Management

The objective of effective capital management is to generate above-market returns on equity to the Corporation's shareholders while maintaining adequate regulatory capital ratios. The Corporation uses capital to fund growth, acquire other companies, pay dividends and repurchase its common stock.

Shareholders' equity at March 31, 2005 decreased to \$312.3 million, representing 6.9 percent of period-end assets compared to \$314.7 million or 7.1 percent of period-end assets at December 31, 2004. The decrease was due mainly to an increase of \$10.9 million in the after-tax unrealized loss on securities-available-for-sale during the three months ended March 31, 2005. The after-tax unrealized loss on securities-available-for-sale at March 31, 2005 was \$15.7 million compared to \$4.9 million at December

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31, 2004. This increase was due to an increase in short- and intermediate-term interest rates. In addition, cash dividends of \$0.19 per share were declared in the first quarter, which resulted in cash dividend payments of \$5.7 million for the three months ended March 31, 2005. These decreases were partially offset by net income of \$10.3 million for the first quarter of 2005.

On January 23, 2002, the Corporation's Board of Directors authorized the repurchase of up to 1.5 million shares of the Corporation's common stock. As of March 31, 2005, the Corporation had repurchased a total of 1.4 million shares of its common stock at an average per-share price of \$17.52 under this authorization, which has reduced shareholders equity by \$24.5 million. No shares were repurchased under this authorization during the three months ended March 31, 2005.

On October 24, 2003, the Corporation's Board of Directors authorized the repurchase of up to 1.5 million additional shares of the Corporation's common stock. At March 31, 2005, no shares had been repurchased under this authorization.

The Corporation's and the Bank's various regulators have issued regulatory capital guidelines for U.S. banking organizations. Failure to meet the capital requirements can initiate certain mandatory and discretionary actions by regulators that could have a material effect on the Corporation's financial statements. At March 31, 2005, the Corporation and the Bank were classified as well capitalized under these regulatory frameworks. In the judgment of management, there have been no events or conditions since March 31, 2005 that would change the well capitalized status of the Corporation or the Bank. The Corporation's capital requirements are summarized in the table below:

**Table Twelve**  
**Capital Ratios**

<i>(Dollars in thousands)</i>	<b>Leverage Capital (1)</b>		<b>Risk-Based Capital</b>			
	<b>Amount</b>	<b>Percentage</b>	<b>Tier 1 Capital (2)</b>		<b>Total Capital (3)</b>	
			<b>Amount</b>	<b>Percentage</b>	<b>Amount</b>	<b>Percentage</b>
Actual	\$ 306,461	6.94%	\$ 306,461	9.89%	\$ 333,980	10.78%
Required	176,726	4.00	123,902	4.00	247,805	8.00
Excess	129,735	2.94	182,559	5.89	86,175	2.78

- (1) Leverage Capital ratios are calculated by dividing Tier 1 Capital by total assets adjusted for intangible assets.
- (2) Tier 1 Capital ratios are calculated by dividing Tier 1 Capital by risk-weighted assets. Tier 1 Capital generally consists of total shareholders' equity less intangible assets and unrealized gains/losses on securities available for sale.
- (3) Total Capital ratios are calculated by dividing Total Capital by risk-weighted assets. Total Capital consists of Tier 1 Capital and Tier 2 Capital. Tier 2 Capital is equal to the allowance for loan losses.

**Regulatory Recommendations**

Management is not presently aware of any current recommendations to the Corporation or to the Bank by regulatory authorities which, if they were to be implemented, would have a material effect on the Corporation's liquidity, capital resources, or operations.

**Accounting Matters**

In November 2003, the Emerging Issues Task Force ( EITF ) issued EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments ( EITF 03-01 ). EITF 03-01 provided guidance for evaluating whether an investment is other-than-temporarily impaired and requires certain disclosures with respect to these investments. In September 2004, the Financial Accounting Standards Board ( FASB ) issued a FASB Staff Position ( FSP EITF 03-1-b ) to delay the requirement to record impairment losses EITF 03-1. The guidance also included accounting considerations subsequent to the recognition of an other-than-temporary impairment and requirements for disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The approved delay by FSP EITF 03-1-b will apply to all securities within the scope of EITF 03-1 and is expected to end when new guidance is issued and comes into effect. The Corporation will evaluate the new guidance on EITF 03-1 upon issuance.

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In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(r) ( SFAS No. 123(r) ), Share-Based Payment , which is a revision of FASB Statement No. 123 Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25 Accounting for Stock Issued to Employees . FASB 123(r) requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees over the period during which an employee is required to provide service in exchange for the award, which is usually the vesting period. FASB 123(r) sets accounting requirements for share-based compensation to employees, including employee-stock purchase plans ( ESPPs ). Awards to most nonemployee directors will be accounted for as employee awards. This Statement is effective for public companies that do not file as small business issuers as of the beginning of interim or annual reporting periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission ( SEC ) issued Release No. 2005-57, which defers the effective date of FASB 123(r) for many registrants. Registrants that do not file as small business users must adopt FASB 123(r) as of the beginning of their first annual period beginning after June 15, 2005. Accordingly, the Corporation will adopt FASB 123(r) on January 1, 2006, and is currently evaluating the effect on its consolidated financial statements.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ), which contains guidance on applying the requirements in SFAS No. 123(r). SAB 107 provides guidance on valuation techniques, development of assumptions used in valuing employee share options and related MD&A disclosures. SAB 107 is effective for the period in which FASB 123(r) is adopted. The Corporation will adopt SAB 107 on January 1, 2006, and is currently evaluating the effect on its consolidated financial statements.

From time to time, the FASB issues exposure drafts for proposed statements of financial accounting standards. Such exposure drafts are subject to comment from the public, to revisions by the FASB and to final issuance by the FASB as statements of financial accounting standards. Management considers the effect of the proposed statements on the consolidated financial statements of the Corporation and monitors the status of changes to and proposed effective dates of exposure drafts.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

See **Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset-Liability Management and Interest Rate Risk** on page 33 for Quantitative and Qualitative Disclosures about Market Risk.

### **Item 4. Controls and Procedures**

(a) Evaluation of disclosure controls and procedures. As of the end of the period covered by this report, an evaluation of the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rule 13(a)-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act )) was performed under the supervision and with the participation of the Corporation's management, including the Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Corporation in its reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

(b) Changes in internal control over financial reporting. During the last fiscal quarter, there has been no change in the Corporation's internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) promulgated under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Corporation's



internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

The Corporation and the Bank are defendants in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated operations, liquidity or financial position of the Corporation or the Bank.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****(c) Issuer Purchases of Equity Securities**

The following table summarizes the Corporation's repurchases of its common stock during the quarter ended March 31, 2005.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2005- January 31, 2005				1,625,400
February 1, 2005- February 28, 2005				1,625,400
March 1, 2005- March 31, 2005				1,625,400
Total				1,625,400

(1) On January 24, 2002, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to 1.5 million shares of the Corporation's common stock from time to time. As of March 31, 2005, the Corporation had repurchased 1,374,600 shares under this authorization. No shares were repurchased under this authorization during the quarter ended March 31, 2005. On November 3, 2003, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to an additional 1.5 million shares of the Corporation's common stock from time to time. As of March 31, 2005, no shares have been repurchased under this authorization. These stock repurchase plans have no set expiration or termination date.

**Item 3. Defaults Upon Senior Securities**

Not Applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not Applicable.

**Item 5. Other Information**

Not Applicable.

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**Item 6. Exhibits**

Exhibit No.

(per Exhibit Table  
in item 601 of

Regulation S-K)

Description of Exhibits

- |      |  |
|------|--|
| 10.1 | Separation Agreement, dated February 1, 2005, by and between the Registrant and Robert O. Bratton, incorporated herein by reference to the Corporation's Current Report on Form 8-K dated February 1, 2005             |
| 10.2 | Employment Agreement, dated April 13, 2005, by and between the Registrant and Charles A. Caswell, incorporated herein by reference to the Corporation's Current Report on Form 8-K dated April 13, 2005                |
| 10.3 | Change in Control Agreement, dated April 13, 2005, by and between the Registrant and Cecil O. Smith, Jr., incorporated herein by reference to the Corporation's Current Report on Form 8-K dated April 13, 2005        |
| 10.4 | Change in Control Agreement, dated April 13, 2005, by and between the Registrant and Stephen J. Antal, incorporated herein by reference to the Corporation's Current Report on Form 8-K dated April 13, 2005           |
| 10.5 | Transition Agreement and Release, dated April 27, 2005, by and between the Registrant and Lawrence M. Kimbrough, incorporated herein by reference to the Corporation's Current Report on Form 8-K dated April 27, 2005 |
| 10.6 | Change in Control Agreement, dated December 19, 2001 by and between the Registrant and Richard A. Manley   |
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                             |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                             |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

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Exhibit No. (per Exhibit Table in item 601 of Regulation S-K)	Description of Exhibits
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FIRST CHARTER CORPORATION  
(Registrant)

Date: May 9, 2005

By: /s/ Charles A. Caswell

Charles A. Caswell  
Executive Vice President &  
Chief Financial Officer

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