COLONIAL BANCGROUP INC
Form 10-Q
November 08, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED September 30, 2006

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM_______TO_______.

COMMISSION FILE NUMBER: 1-13508

THE COLONIAL BANCGROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**63-0661573** **(I.R.S. Employer Identification No.)**
One Commerce Street	
Suite 800	
Montgomery, AL **(Address of principal executive offices)**	**36104** **(Zip Code)**

(334) 240-5000

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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, and (2) has been subject to the filing requirements for at least the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer: in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at October 31, 2006**
Common Stock, $2.50 Par Value	152,952,131

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CAUTIONARY STATEMENT PURSUANT TO SAFE HARBOR PROVISIONS

OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:

FORWARD-LOOKING STATEMENTS

This report and the information incorporated by reference include forward-looking statements within the meaning of the federal securities laws. Words such as believes, estimates, plans, expects, should, may, might, outlook, and anticipates, and similar expressions, as they BancGroup (including its subsidiaries or its management), are intended to identify forward-looking statements. The forward-looking statements in this report are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in or implied by the statements. In addition to factors mentioned elsewhere in this report or previously disclosed in BancGroup s SEC reports (accessible on the SEC s website at *www.sec.gov* or on BancGroup s website at *www.colonialbank.com*), the following factors, among others, could cause actual results to differ materially from forward-looking statements and future results could differ materially from historical performance. These factors are not exclusive:

- deposit attrition, customer loss, or revenue loss in the ordinary course of business;
- increases in competitive pressure in the banking industry;
- costs or difficulties related to the integration of the businesses of BancGroup and institutions it acquires are greater than expected;
- the inability of BancGroup to realize elements of its strategic plans for 2006 and beyond;
- changes in the interest rate environment which expand or reduce margins or adversely affect critical estimates as applied and projected returns on investments;
- economic conditions affecting real estate values and transactions in BancGroup s market and/or general economic conditions, either nationally or regionally, that are less favorable than expected;
- natural disasters in BancGroup s primary market areas result in prolonged business disruption or materially impair the value of collateral securing loans;
- management s assumptions and estimates underlying critical accounting policies prove to be inadequate or materially incorrect or are not borne out by subsequent events;
- changes which may occur in the regulatory environment;
- a significant rate of inflation (deflation);

- acts of terrorism or war; and

- changes in the securities markets.

Many of these factors are beyond BancGroup s control. The reader is cautioned not to place undue reliance on any forward looking statements made by or on behalf of BancGroup. Any such statement speaks only as of the date the statement was made or as of such date that may be referenced within the statement. BancGroup does not undertake any obligation to update or revise any forward-looking statements.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CONDITION

(Unaudited)

	September 30, 2006	December 31, 2005
	(Dollars in thousands)	
ASSETS		
Cash and due from banks	**$ 371,898**	$ 429,549
Interest bearing deposits in banks	**2,161**	9,417
Federal funds sold	**82,323**	59,625
Securities purchased under agreements to resell	**593,572**	589,902
Securities available for sale	**2,958,472**	2,841,404
Investment securities (market value: 2006, $2,107; 2005, $3,126)	**1,971**	2,950
Loans held for sale	**1,322,318**	1,097,892
Total loans, net of unearned income:		
Mortgage warehouse loans	**282,985**	483,701
Loans, excluding mortgage warehouse loans	**15,232,710**	14,416,163
Less:		
Allowance for loan losses	**(176,117)**	(171,051)
Loans, net	**15,339,578**	14,728,813
Premises and equipment, net	**372,980**	340,201
Goodwill	**627,207**	635,413
Other intangibles, net	**50,176**	59,599
Other real estate owned	**2,826**	6,108
Bank-owned life insurance	**354,004**	345,842
Accrued interest and other assets	**333,077**	279,482
Total	**$ 22,412,563**	$ 21,426,197
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest bearing transaction accounts	**$ 2,849,718**	$ 3,167,875
Interest bearing transaction accounts	**6,188,859**	5,845,068
Total transaction accounts	**9,038,577**	9,012,943
Time deposits	**6,473,436**	5,661,715
Brokered time deposits	**283,199**	808,791
Total deposits	**15,795,212**	15,483,449
Repurchase agreements	**882,561**	868,871
Federal funds purchased and other short-term borrowings	**1,285,000**	673,925
Subordinated debt	**383,662**	391,347
Junior subordinated debt	**299,108**	307,446
Other long-term debt	**1,595,621**	1,640,038
Accrued expenses and other liabilities	**147,298**	128,430
Total liabilities	**20,388,462**	19,493,506
Contingencies and commitments (Notes 7 and 13)		

Preferred stock, $2.50 par value; 50,000,000 shares authorized and none issued at both September 30, 2006 and December 31, 2005		
Preference stock, $2.50 par value; 1,000,000 shares authorized and none issued at both September 30, 2006 and December 31, 2005		
Common stock, $2.50 par value; 400,000,000 shares authorized; 156,196,005 and 155,602,747 shares issued and 153,244,378 and 154,242,820 outstanding at September 30, 2006 and December 31, 2005, respectively	**390,490**	389,007
Additional paid in capital	**761,933**	759,704
Retained earnings	**989,255**	868,515
Treasury stock, at cost (2,951,627 shares at September 30, 2006 and 1,359,927 shares at December 31, 2005)	**(71,594)**	(31,510)
Unearned compensation		(6,430)
Accumulated other comprehensive loss, net of taxes	**(45,983)**	(46,595)
Total shareholders equity	**2,024,101**	1,932,691
Total	**$ 22,412,563**	$ 21,426,197

See Notes to the Unaudited Condensed Consolidated Financial Statements

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Dollars in thousands, except per share amounts)			
Interest Income:				
Interest and fees on loans	**$ 331,213**	$ 263,343	**$ 931,415**	$ 701,947
Interest and dividends on securities	**38,707**	34,340	**111,590**	120,770
Interest on federal funds sold and other short-term investments	**11,387**	10,455	**32,427**	18,397
Total interest income	**381,307**	308,138	**1,075,432**	841,114
Interest Expense:				
Interest on deposits	**125,346**	76,968	**336,192**	183,020
Interest on short-term borrowings	**30,154**	22,359	**68,934**	60,803
Interest on long-term debt	**35,255**	23,545	**99,507**	74,632
Total interest expense	**190,755**	122,872	**504,633**	318,455
Net Interest Income	**190,552**	185,266	**570,799**	522,659
Provision for loan losses	**1,450**	6,007	**18,742**	20,946
Net Interest Income After Provision for Loan Losses	**189,102**	179,259	**552,057**	501,713
Noninterest Income:				
Service charges on deposit accounts	**16,642**	15,325	**46,187**	43,784
Financial planning services	**3,944**	3,600	**10,738**	10,621
Electronic banking	**4,470**	3,890	**12,856**	11,316
Mortgage banking	**3,154**	4,456	**9,834**	9,417
Mortgage warehouse fees	**6,105**	4,523	**18,388**	9,225
Bank-owned life insurance	**4,242**	3,621	**12,157**	10,481
Goldleaf income		2,750	**1,171**	7,491
Net cash settlement of swap derivatives		2,514		8,812
Securities and derivatives gains (losses), net	**156**		**4,384**	(4,642)
Change in fair value of swap derivatives		(7,072)		(5,382)
Gain on sale of Goldleaf			**2,829**	
Gain on sale of branches				9,608
Other income	**7,249**	5,719	**20,849**	20,943
Total noninterest income	**45,962**	39,326	**139,393**	131,674
Noninterest Expense:				
Salaries and employee benefits	**72,472**	70,204	**212,180**	196,097
Occupancy expense of bank premises, net	**17,188**	15,990	**49,128**	45,286
Furniture and equipment expenses	**12,333**	11,456	**35,632**	31,893
Professional services	**4,340**	5,487	**13,692**	15,176
Amortization of intangible assets	**3,051**	2,970	**9,159**	8,461
Advertising	**2,278**	3,591	**8,268**	8,513
Communications	**2,838**	2,601	**7,926**	7,541
Merger related expenses		613		3,822
Goldleaf expense		2,307	**964**	6,419
Net losses related to the early extinguishment of debt		1,673		9,550

Other expenses	**17,485**	17,072	**52,123**	50,016
Total noninterest expense	**131,985**	133,964	**389,072**	382,774
Income before income taxes	**103,079**	84,621	**302,378**	250,613
Applicable income taxes	**35,047**	28,145	**102,808**	83,618
Net Income	**$ 68,032**	$ 56,476	**$ 199,570**	$ 166,995
Earnings per share:				
Basic	**$ 0.44**	$ 0.37	**$ 1.30**	$ 1.13
Diluted	**$ 0.44**	$ 0.36	**$ 1.29**	$ 1.12
Average number of shares outstanding:				
Basic	**153,813**	153,721	**153,968**	147,450
Diluted	**154,954**	155,510	**155,217**	149,171
Dividends declared per share	**$ 0.17**	$ 0.1525	**$ 0.51**	$ 0.4575

See Notes to the Unaudited Condensed Consolidated Financial Statements

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(Dollars in thousands)			
Net income	**$ 68,032**	$ 56,476	**$ 199,570**	$ 166,995
Other comprehensive income, net of taxes:				
Unrealized gains (losses) on securities available for sale arising during the period, net of income taxes of $(29,533) and $(467) in 2006 and $10,205 and $12,587 in 2005, respectively	**54,848**	(19,004)	**868**	(23,375)
Less: reclassification adjustment for net (gains) losses on securities available for sale included in net income, net of income taxes of $54 and $660 in 2006 and $0 and $(1,625) in 2005, respectively	**(102)**		**(1,227)**	3,017
Unrealized (losses) gains, net of reclassification adjustments, on cash flow hedging instruments, net of income taxes of $(853) and $1,267 in 2006 and $3,727 and $3,867 in 2005, respectively	**1,584**	(6,888)	**(2,354)**	(7,147)
Additional minimum pension liability adjustment, net of income taxes of $(335) and $(1,675) in 2006	**665**		**3,325**	
Comprehensive income	**$ 125,027**	$ 30,584	**$ 200,182**	$ 139,490

See Notes to the Unaudited Condensed Consolidated Financial Statements

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(Unaudited)

	Common Stock						Accumulated	
	Shares	Amount	Additional Paid In Capital	Treasury Stock	Retained Earnings	Unearned Compensation	Other Comprehensive Loss	Total Shareholders Equity
	(Dollars in thousands, except per share amounts)							
Balance, December 31, 2005	154,242,820	$ 389,007	$ 759,704	$ (31,510)	$ 868,515	$ (6,430)	$ (46,595)	$ 1,932,691
Adoption of SFAS 123(R)			(6,430)			6,430		
Shares issued under:								
Directors plan	58,270	146	869					1,015
Stock option plans	414,142	1,035	3,781					4,816
Restricted stock plan, net	98,342	246	(246)					
Employee Stock Purchase Plan	22,504	56	510					566
Excess tax benefit from stock-based compensation			1,068					1,068
Stock-based compensation expense			2,677					2,677
Purchase of common stock	(1,591,700)			(40,084)				(40,084)
Net income					199,570			199,570
Cash dividends ($0.51 per share)					(78,830)			(78,830)
Change in unrealized loss on securities available for sale, net of taxes							(359)	(359)
Change in unrealized loss on derivative instruments used as cash flow hedges, net of taxes and reclassification adjustments							(2,354)	(2,354)
Additional minimum pension liability adjustment, net of taxes							3,325	3,325
Balance, September 30, 2006	**153,244,378**	**$ 390,490**	**$ 761,933**	**$ (71,594)**	**$ 989,255**	**$**	**$ (45,983)**	**$ 2,024,101**

See Notes to the Unaudited Condensed Consolidated Financial Statements

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW

(Unaudited)

	Nine Months Ended September 30, 2006	2005
	(Dollars in thousands)	
Cash flows from operating activities		
Net income	**$ 199,570**	$ 166,995
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation, amortization and accretion	**8,503**	5,839
Change in fair value of swap derivatives		5,382
Provision for loan losses	**18,742**	20,946
Deferred taxes	**(884)**	2,580
(Gains) losses on securities and derivatives, net	**(4,384)**	4,642
Gains on sales of other assets	**(1,689)**	(3,339)
Gain on sale of branches		(9,608)
Gain on sale of Goldleaf	**(2,829)**	
Net increase in loans held for sale	**(224,426)**	(121,474)
Increase in interest and other receivables	**(21,187)**	(15,262)
(Increase) decrease in prepaids	**(4,706)**	10,614
Increase in other assets	**(30,560)**	(19,853)
Decrease in accrued expenses & accounts payable	**(9,802)**	(37,669)
Increase in accrued income taxes	**6,736**	2,615
Increase in interest payable	**21,333**	8,480
Excess tax benefit from stock based compensation	**(1,068)**	
Other, net	**1,495**	814
Total adjustments	**(244,726)**	(145,293)
Net cash from operating activities	**(45,156)**	21,702
Cash flows from investing activities:		
Proceeds from maturities and calls of securities available for sale	**168,965**	319,820
Proceeds from sales of securities available for sale	**625,152**	1,362,696
Purchases of securities available for sale	**(911,412)**	(681,434)
Proceeds from maturities of investment securities	**990**	3,088
Increase in securities purchased under agreements to resell	**(3,670)**	(385,917)
Net increase in loans excluding proceeds from sales of interests in mortgage warehouse loans	**(603,595)**	(1,045,529)
Proceeds from sales of interests in mortgage warehouse loans		760,620
Net cash paid in bank acquisitions		(114,873)
Net cash paid in branch divestiture		(110,202)
Net cash received from Goldleaf divestiture (gross proceeds of $11.8 million)	**10,558**	
Capital expenditures	**(62,796)**	(29,027)
Proceeds received from life insurance	**7,394**	
Proceeds from sales of other real estate owned	**10,497**	9,425
Proceeds from sales of premises and equipment	**4,062**	2,391
Proceeds from sales of other assets	**6,613**	5,409
Net investment in affiliates	**(17,083)**	(9,813)
Net cash from investing activities	**(764,325)**	86,654
Cash flows from financing activities:		
Net increase in demand, savings and time deposits	**310,399**	2,075,888
Net increase (decrease) in federal funds purchased, repurchase agreements and other short-term borrowings	**624,765**	(1,749,062)
Proceeds from issuance of long-term debt	**200,000**	751,502

Repayment of long-term debt	**(255,428)**	(1,122,562)
Purchase of common stock	**(40,084)**	(31,510)
Proceeds from issuance of common stock	**5,382**	6,652
Proceeds from issuance of shares under forward equity sales agreement		179,575
Excess tax benefit from stock-based compensation	**1,068**	
Dividends paid	**(78,830)**	(66,187)
Net cash from financing activities	**767,272**	44,296
Net (decrease) increase in cash and cash equivalents	**(42,209)**	152,652
Cash and cash equivalents at the beginning of the year	**498,591**	382,877
Cash and cash equivalents at September 30	**$ 456,382**	$ 535,529
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	**$ 477,127**	$ 310,468
Taxes	**103,425**	74,000
Non-cash investing and financing activities:		
Transfer of loans to other real estate	**$ 7,786**	$ 7,256
Assets (non-cash) acquired in business combinations		2,335,163
Liabilities assumed in business combinations		1,946,153
Assets (non-cash) sold in Goldleaf divestiture	**12,236**	
Liabilities sold in Goldleaf divestiture	**4,507**	
Assets acquired under capital leases	**2,663**	

See Notes to the Unaudited Condensed Consolidated Financial Statements

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Accounting Policies

The accounting and reporting policies of The Colonial BancGroup, Inc. and its subsidiaries (referred to herein as BancGroup , Colonial , or the Company) are detailed in the Company s 2005 Annual Report on Form 10-K. As discussed more fully below, effective January 1, 2006 the Company changed certain of those policies as a result of the adoption of new accounting standards. These unaudited interim financial statements should be read in conjunction with the audited financial statements and footnotes included in BancGroup s 2005 Annual Report on Form 10-K.

In the opinion of BancGroup, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly BancGroup s financial position as of September 30, 2006 and December 31, 2005 and the results of operations and cash flows for the interim periods ended September 30, 2006 and 2005. All 2006 interim amounts have not been audited, and the results of operations for the interim periods herein are not necessarily indicative of the results of operations to be expected for the year.

Certain reclassifications were made to prior periods in order to conform with the current period presentation.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. Under SFAS 123(R), all stock-based payments are measured at fair value at the date of grant and expensed over their vesting or service period. The expense will be recognized using the straight-line method. Prior to January 1, 2006, the Company accounted for stock based-compensation under the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB 25, compensation cost was only recognized for the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount an employee must pay to acquire the stock. As such, under APB 25 the Company generally recognized no compensation expense for stock options since the exercise prices equaled the market price of BancGroup common stock on the grant dates. The Company did, however, recognize compensation cost for restricted stock awards since such awards have no exercise price.

The Company adopted SFAS 123(R) using the modified prospective transition method under which compensation cost is recognized beginning on January 1, 2006 (a) based on the requirements of SFAS 123(R) for all awards granted on or after January 1, 2006 and (b) based on the requirements of SFAS 123 for all awards granted prior to, and that remain unvested as of, January 1, 2006. The modified prospective transition method does not require the restatement of prior periods to reflect the fair value method of expensing stock-based compensation. SFAS 123(R) does require a cumulative effect adjustment of previously recognized compensation expense in order to estimate forfeitures for awards outstanding on the adoption date. The cumulative effect adjustment was immaterial.

The adoption of SFAS 123(R) had the following effects on the Company s financial results for the three and nine months ended September 30, 2006 (in thousands, except per share amounts):

	Three months ended September 30, 2006	Nine months ended September 30, 2006
Income before taxes	$ (469)	$ (1,469)
Net income	(428)	(1,364)
Basic earnings per share	(0.00)	(0.01)
Diluted earnings per share	(0.00)	(0.01)
Cash flows from operating activities	(450)	(1,068)
Cash flows from financing activities	450	1,068

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Total compensation cost for stock-based compensation awards (both stock options and restricted stock awards) recognized under the fair value method during the three and nine months ended September 30, 2006 was $872,000 and $2.7 million, respectively. The related income tax benefit was $189,000 and $552,000, respectively. Pro forma financial information as if compensation cost had been recognized under the fair value method for the three and nine months ended September 30, 2005 is as follows:

	Three months ended September 30, 2005	Nine months ended September 30, 2005
	(Dollars in thousands, except per share data)	
Net income:		
As reported	$ 56,476	$ 166,995
Add: Stock-based employee compensation expense determined under intrinsic value method included in reported net income, net of tax	204	649
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of tax	(594)	(1,883)
Pro forma net income	$ 56,086	$ 165,761
Basic earnings per share:		
As reported	$ 0.37	$ 1.13
Pro forma	$ 0.36	$ 1.12
Diluted earnings per share:		
As reported	$ 0.36	$ 1.12
Pro forma	$ 0.36	$ 1.11

The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used in the model include the exercise price of the award, the expected option term, the expected volatility of the Company s stock over the option s expected term, the risk-free interest rate over the option s expected term and the Company s expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in estimating the fair value of the Company s stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the stock option recipients. As a result of implementing SFAS 123(R), the Company refined its process for estimating expected option term and expected stock price volatility.

The fair value of each option grant was estimated on the grant date using the Black-Scholes option pricing model with the following assumptions:

	Three months ended September 30, 2006	Three months ended September 30, 2005
Expected option term	5.33 years	5 years
Weighted average expected volatility	23.11%	24.90%
Weighted average risk-free interest rate	4.81%	4.04%
Weighted average expected annual dividend yield	2.70%	2.62%

	Nine months ended September 30, 2006	Nine months ended September 30, 2005

Expected option term	5.33 years	5 years
Weighted average expected volatility	22.81%	24.90%
Weighted average risk-free interest rate	4.82%	3.86%
Weighted average expected annual dividend yield	2.70%	2.83%

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THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For options granted during the nine months ended September 30, 2006, the expected option term was determined based upon the Company s historical experience with employees exercise and post-vesting termination behavior. The expected volatility was determined based upon historical daily prices of the Company s common stock over the most recent period equal to the expected option term, as well as implied price volatility based on the Company s exchange traded options. The indicated historical and implied volatilities were weighted 75% and 25%, respectively. Less emphasis was placed on implied volatility compared to historical volatility because the volume of exchange traded options is relatively low. The risk-free rate was determined based on the interpolated rate as of the grant date of a zero coupon treasury security with a maturity equal to the expected option term. The expected annual dividend yield was determined based on forecasted dividends for 2006 and the Company s stock price as of December 31, 2005.

For options granted during the nine months ended September 30, 2005, the expected option term was determined based on consideration of the option attributes (five year graded vesting; ten year total option life) as well as the guidance of SFAS 123 which stated that when presented with a range of reasonable estimates for expected option life, if no amount within the range is a better estimate than any other amount, it is appropriate to use an estimate at the low end of the range. The expected volatility was determined based on analysis of historical monthly prices of the Company s common stock over the most recent period equal to the expected option term. The risk-free rate was determined based on the rate of a constant maturity treasury security with a maturity equal to the expected option term. The expected annual dividend yield was determined based on forecasted dividends for 2005 and the Company s stock price as of the grant date.

See Note 12 for additional information on stock based compensation.

Accounting Changes and Error Corrections

Effective January 1, 2006, the Company adopted SFAS 154, *Accounting Changes and Error Corrections*, which replaced APB 20, *Accounting Changes*, and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 requires that certain changes in accounting principle be retrospectively applied. Under retrospective application, the new accounting principle is applied as of the beginning of the first period presented as if that principle has always been used. The cumulative effect of the change is reflected in the carrying value of assets and liabilities as of the first period presented, and the offsetting adjustments are recorded to opening retained earnings. Each period presented is adjusted to reflect the period-specific effects of applying the change. Only direct effects of the change will be included in the retrospective application; all indirect effects will be recognized in the period of change. SFAS 154 applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. The adoption of SFAS 154 did not have a material impact on the Company s financial statements.

Other-Than-Temporary Impairment of Securities

Effective January 1, 2006, the Company adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Refer to Note 3 for related disclosures. The adoption of FSP 115-1 did not have a material impact on the Company s financial statements.

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2: Recent Accounting Standards

In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Instruments*. This Statement amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and resolves issues addressed in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*.

SFAS 155 permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, and amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. In addition, SFAS 155 establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. This Statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133 and makes clear that concentrations of credit risk in the form of subordination are not embedded derivatives.

SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. The fair value election provided for in this guidance may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under SFAS 133 prior to the adoption of this guidance. The changes required by SFAS 155 are not expected to have a material impact on the Company s financial statements.

In March 2006, the FASB issued SFAS 156, *Accounting for Servicing of Financial Assets.* SFAS 156 amends SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 permits an entity to choose to either subsequently measure servicing rights at fair value and report changes in fair value in earnings, or amortize servicing rights in proportion to and over the estimated net servicing income or loss and assess the rights for impairment or need for an increased obligation.

This Statement is effective as of the beginning of an entity s fiscal year that begins after September 15, 2006. The requirement to recognize and initially measure servicing assets and liabilities at fair value should be applied prospectively to all transactions after the adoption of the Statement. The changes required by SFAS 156 are not expected to have a material impact on the Company s financial statements.

In April 2006, the FASB issued FASB Staff Position (FSP) FIN 46(R)-6, *Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)*. The FSP addresses how a reporting enterprise should determine the variability to be considered in applying FIN 46(R), which affects the determination of (a) whether the entity is a variable interest entity (VIE), (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. That variability will affect any calculation of expected losses and expected residual returns if such a calculation is necessary. The guidance in the FSP is to be applied prospectively to all entities with which the enterprise first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred beginning the first day of the first reporting period beginning after June 15, 2006. The changes required by FSP FIN 46(R)-6 did not have a material impact on the Company s financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes*, which establishes a two-step process for recognizing and measuring tax benefits. It applies to all tax positions within the scope of SFAS 109, *Accounting for Income Taxes*. Under FIN 48, tax benefits can only be recognized

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in the financial statements if it is more likely than not that they would be sustained after full review by the relevant taxing authority. If a tax position meets the recognition threshold, the benefit to be recorded is equal to the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority. Any difference between the full amount of the tax benefit and the amount recorded in the financial statements will be recognized as higher tax expense. Required disclosures will include a tabular rollforward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings. BancGroup does not expect that the adoption of FIN 48 will have a material impact on the Company s financial statements.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. Prior to SFAS 157, there were different definitions of fair value and limited guidance for applying those definitions. Moreover, that guidance was dispersed among the many accounting pronouncements that require or permit fair value measurements. SFAS 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. The Statement does not expand the use of fair value in any new circumstances.

SFAS 157 is effective for fiscal years beginning after November 15, 2007. The provisions of the Statement will be applied prospectively as of the effective date, except in limited circumstances in which the provisions will be applied retrospectively to certain securities and financial instruments as a cumulative effect adjustment to the opening balance of retained earnings. The changes required by SFAS 157 are not expected to have a material impact on the Company s financial statements.

In September 2006, the FASB issued SFAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*. SFAS 158 requires companies to fully recognize the overfunded or underfunded status of defined benefit pension plans as assets or liabilities, respectively. The funded status is measured as the difference between the fair value of the plan s assets and the projected benefit obligation. In addition, SFAS 158 requires companies to measure plan assets and benefit obligations as of year-end. Currently, companies are permitted to choose a measurement date up to three months prior to year-end. The provision to require recognition of the funded status of the plan will be effective for fiscal years ending after December 15, 2006. The provision to require measurement of assets and obligations at year-end will be effective for fiscal years ending after December 15, 2008. The measurement date utilized by BancGroup for its pension plan is the Company s year end. On December 31, 2005, BancGroup closed its pension plan to new employees and set the compensation amount and years of service for the future benefits calculation for participants. The changes required by SFAS 158 are not expected to have a material impact on the Company s financial statements.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. Issue 06-4 stipulates that an agreement by the employer to share a portion of the proceeds of a life insurance policy with the employee during the postretirement period is a postretirement benefit arrangement for which a liability must be recorded. The consensus is effective for fiscal years beginning after December 15, 2007. Entities will have the option of applying the provisions of Issue 06-4 as a cumulative effect adjustment to the opening balance of retained earnings or retrospectively to all prior periods. The changes required by Issue 06-4 are not expected to have a material impact on the Company s financial statements.

In September 2006, the EITF reached a final consensus on Issue No. 06-5, *Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin*

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No. 85-4, Accounting for Purchases of Life Insurance. Issue 06-5 stipulates that the cash surrender value and any additional amounts provided by the contractual terms of the insurance policy that are realizable at the balance sheet date should be considered in determining the amount that could be realized under FTB 85-4, and any amounts that are not immediately payable to the policyholder in cash should be discounted to their present value. Also, in determining the amount that could be realized, companies should assume that policies will be surrendered on an individual-by-individual basis, rather than surrendering the entire group policy. The consensus is effective for fiscal years beginning after December 15, 2006. Entities will have the option of applying the provisions of Issue 06-5 as a cumulative effect adjustment to the opening balance of retained earnings or retrospectively to all prior periods. The changes required by Issue 06-5 are not expected to have a material impact on the Company s financial statements.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 was issued in order to eliminate the diversity in practice surrounding how public companies quantify financial statement misstatements.

Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements: the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements, but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the Company's financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it requires quantification of errors under both the iron curtain and the roll-over methods.

SAB 108 is effective for financial statements of fiscal years ending after November 15, 2006. The changes required by SAB 108 are not expected to have a material impact on the Company s financial statements.

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Note 3: Securities

The composition of the Company s securities portfolio is reflected in the following table:

Securities by Category

	Carrying Value at September 30, 2006	Carrying Value at December 31, 2005
	(Dollars in thousands)	
Securities available for sale:		
U.S. Treasury securities and obligations of U.S. Government Sponsored Entities	**$ 166,523**	$ 184,557
Mortgage-backed securities of Government Sponsored Entities	**358,133**	359,691
Collateralized mortgage obligations of Government Sponsored Entities	**874,170**	698,763
Private collateralized mortgage obligations	**1,362,284**	1,412,004
Obligations of state and political subdivisions	**44,437**	42,056
Other	**152,925**	144,333
Total securities available for sale	**2,958,472**	2,841,404
Investment securities:		
U.S. Treasury securities and obligations of U.S. Government Sponsored Entities	**500**	500
Mortgage-backed securities of Government Sponsored Entities	**772**	957
Collateralized mortgage obligations of Government Sponsored Entities	**11**	13
Obligations of state and political subdivisions	**688**	1,480
Total investment securities	**1,971**	2,950
Total securities	**$ 2,960,443**	$ 2,844,354

The following table reflects gross unrealized losses and market value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2006.

	Less than 12 months		12 months or more		Total	
	Market Value	Unrealized Losses	Market Value	Unrealized Losses	Market Value	Unrealized Losses
			(Dollars in thousands)			
U.S. Treasury obligations and direct obligations of U.S. Government Sponsored Entities	$	$	$ 166,523	$ (8,477)	$ 166,523	$ (8,477)
Mortgage-backed securities of Government Sponsored Entities	75,445	(139)	222,180	(11,061)	297,625	(11,200)
Collateralized mortgage obligations of Government Sponsored Entities	264,576	(1,593)	433,900	(12,420)	698,476	(14,013)
Private collateralized mortgage obligations	247,037	(1,971)	866,496	(22,510)	1,113,533	(24,481)
Obligations of state and political subdivisions	2,228	(3)	3,897	(17)	6,125	(20)

Total temporarily impaired securities	$ 589,286	$ (3,706)	$ 1,692,996	$ (54,485)	$ 2,282,282	$ (58,191)

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As of September 30, 2006, there were 196 securities with an unrealized loss relating to the level of interest rates prevailing in the market. Because of the creditworthiness of the issuers and because the future direction of interest rates is unknown, the impairments are deemed to be temporary. The severity and duration of such impairments are determined by the level of interest rates set by the market. Additionally, BancGroup has the ability to retain these securities until maturity when full repayment would be received. There are also no known current funding needs which would require their liquidation.

Note 4: Loans

A summary of the major categories of loans outstanding is shown in the table below.

	September 30, 2006	December 31, 2005
	(Dollars in thousands)	
Commercial, financial, agricultural	**$ 1,116,029**	$ 1,107,494
Commercial real estate	**4,340,496**	4,424,465
Real estate construction	**6,308,354**	5,483,424
Residential real estate	**3,051,965**	3,048,007
Consumer and other loans	**435,338**	372,470
Total loans, excluding mortgage warehouse loans	**15,252,182**	14,435,860
Mortgage warehouse loans	**282,985**	483,701
Total loans	**15,535,167**	14,919,561
Less: unearned income	**(19,472)**	(19,697)
Total loans, net of unearned income	**$ 15,515,695**	$ 14,899,864

Note 5: Allowance for Loan Losses

An analysis of the allowance for loan losses is as follows:

	September 30, 2006
	(Dollars in thousands)
Balance, January 1	**$ 171,051**
Provision charged to income	**18,742**
Loans charged off	**(24,479)**
Recoveries	**10,803**
Balance, September 30	**$ 176,117**

Note 6: Sales and Servicing of Financial Assets

During the first quarter of 2005, the Company structured a facility in which it sold certain mortgage warehouse loans and mortgage loans held for sale to a wholly-owned special purpose entity (SPE) which then sold interests in those assets to third-party commercial paper conduits (conduits).

During the third quarter of 2006, the Company sold an additional $500 million to the conduits, bringing the total outstanding balance to $2.0 billion at September 30, 2006. Based on the structure of these transactions, the Company s only retained interest is the assets retained in the SPE as a first risk of loss position. No gain or loss was recorded at the time of sale. The Company receives servicing income based on a percentage of the outstanding balance of assets sold. During the third quarter of 2006, the Company recognized approximately $5.1

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million of noninterest income related to these transactions, of which approximately $4.4 million was servicing income, and received $5.0 million in cash. For the nine months ended September 30, 2006, the Company recognized approximately $16.1 million of noninterest income related to these transactions, of which approximately $11.9 million was servicing income, and received $16.4 million in cash.

The following table presents a summary of the components of managed financial assets, representing both owned and sold assets, along with quantitative information about delinquencies and net credit losses:

	As of September 30, 2006		Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	Principal Balance	Loans past due 30 days or more	Average Balance	Net Credit Losses(1)	Average Balance	Net Credit Losses(1)
	(Dollars in thousands)					
Mortgage warehouse loans:						
Assets managed	$ 682,722	$	$ 717,199	$	$ 845,047	$
less: interests sold, with servicing retained	399,737		378,380		464,859	
Assets held in portfolio	$ 282,985	$	$ 338,819	$	$ 380,188	$
Loans held for sale:						
Assets managed	$ 2,922,581	$	$ 3,018,509	$	$ 2,453,401	$
less: interests sold	1,600,263		1,339,011		1,108,401	
Assets held in portfolio	$ 1,322,318	$	$ 1,679,498	$	$ 1,345,000	$

(1) Represents net charge-offs.

Note 7: Guarantees

Standby letters of credit are contingent commitments issued by Colonial Bank, N.A. generally to guarantee the performance of a customer to a third-party. A financial standby letter of credit is a commitment by Colonial Bank, N.A. to guarantee a customer s repayment of an outstanding loan or debt instrument. In a performance standby letter of credit, Colonial Bank, N.A. guarantees a customer s performance under a contractual nonfinancial obligation for which it receives a fee. These guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The Company holds various assets as collateral supporting those commitments for which collateral is deemed necessary. FIN No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, requires the fair value of these commitments to be recorded on the balance sheet. The fair value of the commitment typically approximates the fee received from the customer for issuing such commitments. These fees are deferred and are recognized over the commitment period. The amount recorded for deferred fees as of September 30, 2006 was not material to the Company s consolidated balance sheet. At September 30, 2006, Colonial Bank, N.A. had standby letters of credit outstanding with maturities of generally one year or less. The maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit was approximately $338 million.

Note 8: Variable Interest Entities

Colonial invested in five variable interest entities during the first nine months of 2006. Four of the entities were formed for the purpose of developing residential real estate and one entity provides home automation

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products. One of the investments in a residential real estate developer was sold in the second quarter of 2006. The entities are not required to be consolidated under the guidance of FIN 46(R). The four remaining investments had total assets of $23.1 million, and the Company s maximum exposure to loss totaled $19.8 million at September 30, 2006.

There has been no material change in the Company s other variable interest entities. Refer to the Company s 2005 Annual Report on Form 10-K for additional information.

Note 9: Derivatives

BancGroup maintains positions in derivative financial instruments to manage interest rate risk and facilitate asset/liability management strategies. Derivatives are recorded at fair value in other assets or other liabilities.

Interest Rate Swaps

Fair Value Hedges

At September 30, 2006, BancGroup had interest rate swap positions hedging subordinated debt and brokered CDs. The notional amounts and fair values of all interest rate swaps as of September 30, 2006 are shown below:

	September 30, 2006	
	Notional Amount	Fair Value
	(Dollars in thousands)	
Interest rate swaps hedging subordinated debt	$ 337,292	$ (1,459)
Interest rate swaps hedging brokered CDs	26,000	(26)
	$ 363,292	$ (1,485)

The Company enters into fair value hedges to effectively convert the interest rates of certain instruments from fixed to floating. The Company recognized losses due to hedge ineffectiveness of approximately $78,000 for the three months ended September 30, 2006 and approximately $205,000 for the nine months ended September 30, 2006. There were no hedging gains or losses resulting from hedge ineffectiveness recognized for the three or nine months ended September 30, 2005.

Cash Flow Hedges

During the second quarter of 2006, the Company terminated interest rate swaps which were used in cash flow hedges of loans. The hedged forecasted transactions are still considered probable of occurring, therefore the net loss will remain in accumulated other comprehensive loss and be reclassified into earnings in the same periods during which the hedged forecasted transactions affect earnings (ending in June of 2008). The estimated amount of losses to be reclassified into earnings within the next 12 months is $6.3 million. There were no cash flow hedging gains or losses resulting from hedge ineffectiveness recognized for the three or nine months ended September 30, 2006 or September 30, 2005.

Commitments to Originate and Sell Mortgage Loans

BancGroup, as part of its retail mortgage loan production activities, routinely enters into short-term commitments to originate loans (commonly referred to as interest rate locks). Many of these loans will be sold to

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third parties upon closing. For those loan commitments, the Company enters into an individual forward sales commitment at the same time the commitment to originate is finalized. While the forward sales commitments function as an economic offset and effectively eliminate the Company s financial risk of rate changes during the rate lock period, both the commitment to originate mortgage loans that will be sold and the commitment to sell the mortgage loans are derivatives, the fair values of which are substantially equal and offsetting.