

FIRST CHARTER CORP /NC/

Form 10-Q

August 05, 2004

**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 June 30, 2004

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 Number)

**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 Rule 12b-2 of the Exchange Act). Yes  No

As of August 4, 2004 the Registrant had outstanding 29,778,832 shares of Common Stock, no par value.

**First Charter Corporation**

**Form 10-Q for the Quarterly Period Ended June 30, 2004**

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

	<b>June 30 2004</b>	<b>December 31 2003</b>
<b>(Dollars in thousands, except share data)</b>	<b>(Unaudited)</b>	
<b>Assets:</b>		
Cash and due from banks	\$ 94,749	\$ 88,564
Federal funds sold	1,960	1,311
Interest bearing bank deposits	19,513	23,631
	<u>116,222</u>	<u>113,506</u>
Cash and cash equivalents		
	<u>116,222</u>	<u>113,506</u>
Securities available for sale (cost of \$1,635,431 and \$1,591,803; carrying amount of pledged collateral \$1,183,742 and \$1,129,474)	1,604,585	1,601,900
Loans held for sale	26,768	5,137
Loans	2,348,235	2,252,804
Less: Unearned income	(197)	(167)
Allowance for loan losses	(26,052)	(25,607)
	<u>2,321,986</u>	<u>2,227,030</u>
Loans, net		
	<u>2,321,986</u>	<u>2,227,030</u>
Premises and equipment, net	95,416	95,756
Other assets	174,236	163,364
	<u>95,416</u>	<u>95,756</u>
	<u>174,236</u>	<u>163,364</u>
<b>Total assets</b>	<b>\$4,339,213</b>	<b>\$4,206,693</b>
	<u>\$4,339,213</u>	<u>\$4,206,693</u>
<b>Liabilities:</b>		
Deposits, domestic:		
Noninterest bearing demand	\$ 368,738	\$ 326,679
Interest bearing	2,226,027	2,101,218
	<u>368,738</u>	<u>326,679</u>
	<u>2,226,027</u>	<u>2,101,218</u>
Total deposits	2,594,765	2,427,897
	<u>2,594,765</u>	<u>2,427,897</u>

Other borrowings	<b>1,410,481</b>	1,432,200
Other liabilities	<b>50,186</b>	47,157
	<hr/>	<hr/>
<b>Total liabilities</b>	<b>4,055,432</b>	3,907,254
	<hr/>	<hr/>
<b>Shareholders equity:</b>		
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>29,768,986</b> and 29,720,163 shares		
	<b>116,101</b>	115,270
Common stock held in Rabbi Trust for deferred compensation	<b>(739)</b>	(636)
Deferred compensation payable in common stock	<b>739</b>	636
Retained earnings	<b>186,496</b>	178,008
Accumulated other comprehensive (loss) income:		
Unrealized (loss) gain on securities available for sale, net	<b>(18,816)</b>	6,161
	<hr/>	<hr/>
<b>Total shareholders equity</b>	<b>283,781</b>	299,439
	<hr/>	<hr/>
<b>Total liabilities and shareholders equity</b>	<b>\$4,339,213</b>	\$4,206,693
	<hr/>	<hr/>

See accompanying notes to consolidated financial statements.

## First Charter Corporation and Subsidiaries

Consolidated Statements of Income  
(Unaudited)

(Dollars in thousands, except share and per share data)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
<b>Interest income:</b>				
Loans	\$ 29,285	\$ 30,504	\$ 58,478	\$ 60,795
Federal funds sold	3	6	6	11
Interest bearing bank deposits	39	159	83	339
Securities	15,579	14,472	31,569	29,364
	<u>44,906</u>	<u>45,141</u>	<u>90,136</u>	<u>90,509</u>
Total interest income				
<b>Interest expense:</b>				
Deposits	8,619	11,667	16,744	23,132
Federal funds purchased and securities sold under agreements to repurchase	600	551	1,183	1,043
Federal Home Loan Bank and other borrowings	5,655	6,884	11,804	13,712
	<u>14,874</u>	<u>19,102</u>	<u>29,731</u>	<u>37,887</u>
Total interest expense				
<b>Net interest income</b>	<b>30,032</b>	26,039	<b>60,405</b>	52,622
<b>Provision for loan losses</b>	<b>2,000</b>	19,492	<b>5,000</b>	21,543
	<u>28,032</u>	<u>6,547</u>	<u>55,405</u>	<u>31,079</u>
<b>Net interest income after provision for loan losses</b>	<b>28,032</b>	6,547	<b>55,405</b>	31,079
<b>Noninterest income:</b>				
Service charges on deposit accounts	6,346	5,571	11,951	10,701
Financial management income	1,545	488	3,047	1,066
Gain on sale of securities	494	8,286	820	9,512
Gain on sale of credit card loan portfolio				2,213
Loss from equity method investments	(76)	(276)	(300)	(376)
Mortgage services income	596	643	1,024	1,284
Brokerage services income	902	812	1,872	1,298
Insurance services income	2,634	2,229	5,665	4,666
Trading (losses) gains	(5)	432	104	1,596
Bank owned life insurance	847	967	1,697	1,913
Gain on sale of properties			777	
Other	1,607	1,063	2,898	1,881

Total noninterest income	<u>14,890</u>	<u>20,215</u>	<u>29,555</u>	<u>35,754</u>
<b>Noninterest expense:</b>				
Salaries and employee benefits	14,368	12,585	29,391	26,311
Occupancy and equipment	4,379	3,913	8,616	8,079
Data processing	1,006	634	1,868	1,312
Marketing	1,126	1,161	2,244	2,314
Postage and supplies	1,306	1,152	2,577	2,288
Professional services	2,361	3,230	5,073	5,002
Telephone	507	513	1,001	1,116
Amortization of intangibles	96	77	214	162
Prepayment costs on borrowings		7,366		7,366
Other	2,536	2,357	5,009	5,071
Total noninterest expense	<u>27,685</u>	<u>32,988</u>	<u>55,993</u>	<u>59,021</u>
<b>Income (loss) before income taxes</b>	<b>15,237</b>	<b>(6,226)</b>	<b>28,967</b>	<b>7,812</b>
<b>Income tax expense (benefit)</b>	<b>4,982</b>	<b>(2,022)</b>	<b>9,472</b>	<b>2,070</b>
<b>Net income (loss)</b>	<b>\$ 10,255</b>	<b>\$ (4,204)</b>	<b>\$ 19,495</b>	<b>\$ 5,742</b>
<b>Net income (loss) per share:</b>				
Basic	\$ 0.34	\$ (0.14)	\$ 0.65	\$ 0.19
Diluted	\$ 0.34	\$ (0.14)	\$ 0.65	\$ 0.19
<b>Weighted average shares:</b>				
Basic	29,763,619	29,801,059	29,765,952	29,903,170
Diluted	30,067,462	29,801,059	30,061,529	30,079,806

See accompanying notes to consolidated financial statements.

**First Charter Corporation and Subsidiaries**

**Consolidated Statements of Shareholders Equity**

(Unaudited)

(Dollars in thousands, except share data)	Common Stock		Common Stock held in Rabbi Trust	Deferred Compensation for Payable	Deferred in Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Compensation	Stock	Stock	Earnings	(Loss)	
<b>Balance, December 31, 2002</b>	30,069,147	\$122,870	\$(476)	\$476	\$185,900	\$ 15,916	\$324,686	
Comprehensive income:								
Net income					5,742		5,742	
Unrealized gain on securities available for sale, net						529	529	
Total comprehensive income							6,271	
Common stock purchased by Rabbi Trust for deferred compensation			(99)				(99)	
Deferred compensation payable in common stock				99			99	
Cash dividends					(11,054)		(11,054)	
Stock options exercised	55,701	772					772	
Purchase and retirement of common stock	(365,000)	(6,759)					(6,759)	
<b>Balance, June 30, 2003</b>	<b>29,759,848</b>	<b>\$116,883</b>	<b>\$(575)</b>	<b>\$575</b>	<b>\$180,588</b>	<b>\$ 16,445</b>	<b>\$313,916</b>	
<b>Balance, December 31, 2003</b>	<b>29,720,163</b>	<b>\$115,270</b>	<b>\$(636)</b>	<b>\$636</b>	<b>\$178,008</b>	<b>\$ 6,161</b>	<b>\$299,439</b>	
Comprehensive income:								
Net income					19,495		19,495	
Unrealized loss on securities available for sale, net						(24,977)	(24,977)	
Total comprehensive loss							(5,482)	
Common stock purchased by Rabbi Trust for deferred compensation			(103)				(103)	
Deferred compensation payable in common stock				103			103	
Cash dividends					(11,007)		(11,007)	



Stock options exercised	<u>48,823</u>	<u>831</u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>831</u>
<b>Balance, June 30, 2004</b>	<b><u>29,768,986</u></b>	<b><u>\$116,101</u></b>	<b><u>\$(739)</u></b>	<b><u>\$739</u></b>	<b><u>\$186,496</u></b>	<b><u>\$(18,816)</u></b>	<b><u>\$283,781</u></b>

See accompanying notes to consolidated financial statements.

**First Charter Corporation and Subsidiaries**

**Consolidated Statements of Cash Flows**

(Unaudited)

(Dollars in thousands)	Six Months Ended June 30	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net income	\$ 19,495	\$ 5,742
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	5,000	21,543
Depreciation	4,551	4,591
Amortization of intangibles	214	162
Premium amortization and discount accretion, net	2,141	3,232
Net gain on securities available for sale transactions	(820)	(9,512)
Net gain on sale of foreclosed assets	(48)	(10)
Net loss (gain) on sale of equipment	64	(3)
Gain on sale of credit card loan portfolio		(2,213)
Loss from equity method investments	300	376
Net gain on sale property	(777)	
Origination of mortgage loans held for sale	(56,606)	(248,993)
Proceeds from sale of mortgage loans held for sale	13,689	130,231
Increase in cash surrender value of bank owned life insurance	(1,697)	(1,913)
Decrease in other assets	5,721	1,260
Increase (decrease) in other liabilities	3,029	(16,596)
	<u>(5,744)</u>	<u>(112,103)</u>
<b>Cash flows from investing activities:</b>		
Proceeds from sales of securities available for sale	38,023	846,513
Proceeds from maturities of securities available for sale	235,513	280,203
Purchase of securities available for sale	(297,198)	(1,277,433)
Net increase in loans and loans held for sale	(107,472)	(72,168)
Proceeds from sale of loans	5,828	53,462
Proceeds from sales of other real estate	2,292	7,144
Net purchases of premises and equipment	(3,498)	(5,745)
	<u>(126,512)</u>	<u>(168,024)</u>
<b>Cash flows from financing activities:</b>		
Net increase in demand, money market and savings accounts	145,485	258,154
Net increase (decrease) in certificates of deposit	21,382	(22,251)

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Net (decrease) increase in securities sold under repurchase agreements and other borrowings	(21,719)	34,155
Purchase and retirement of common stock		(6,759)
Proceeds from issuance of common stock	831	772
Dividends paid	(11,007)	(11,054)
	<u>          </u>	<u>          </u>
Net cash provided by financing activities	134,972	253,017
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	2,716	(27,110)
Cash and cash equivalents at beginning of period	113,506	169,850
	<u>          </u>	<u>          </u>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 116,222</b>	<b>\$ 142,740</b>
	<u>          </u>	<u>          </u>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid for interest	\$ 30,473	\$ 38,906
Cash paid for income taxes	9,410	12,501
<b>Supplemental disclosure of non-cash transactions:</b>		
Transfer of loans and premises and equipment to other real estate	1,690	3,739
Unrealized (loss) gain on securities available for sale (net of tax effect of (\$15,966) and \$325, respectively)	(24,977)	529
Loans held for sale securitized and transferred to the securities available for sale portfolio	21,286	251,587
Allowance related to loans sold	549	20,783

See accompanying notes to consolidated financial statements.

## **FIRST CHARTER CORPORATION AND SUBSIDIARIES**

### **NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) For the Three Months Ended June 30, 2004 and 2003**

First Charter Corporation (the Corporation) is a regional financial services company with assets of approximately \$4.3 billion and is the holding company for First Charter Bank (FCB or the Bank). FCB is a full-service bank and trust company with 54 financial centers and six insurance offices located in 18 counties throughout the piedmont and western half of North Carolina. FCB also operates one mortgage origination office in Virginia. FCB provides businesses and individuals with a broad range of financial services, including banking, comprehensive 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, FCB. 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, 2003, 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 53 to 61 of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2003. With the exception of the Corporation's policy regarding derivative instruments, these policies have not materially changed from the year ended December 31, 2003.

#### *Derivative Instruments*

The Corporation enters into interest rate swap agreements as business conditions warrant. These interest rate swap agreements provide an exchange of interest payments computed on notional amounts that will offset any undesirable change in fair value resulting from market rate changes on designated hedged items. A swap agreement is a contract between two parties to exchange cash flows based on specified underlying notional amounts, assets and/or indices. The interest rate swap agreements utilized by the Corporation qualify for hedge accounting as fair value hedges.

The Corporation accounts for these interest rate swaps as a hedge of the fair value of the related Federal Home Loan Bank (FHLB) advances. Accordingly, the Corporation records on a quarterly basis, in noninterest income, the net change in the fair value of the interest rate swap and the related FHLB advances (ineffectiveness), provided the criteria for hedge accounting continue to be met. In the event such criteria are not met in a future period, the Corporation will only record changes in the fair value on the interest rate swap. The derivative hedging instruments are recorded at fair value in other assets or other liabilities.

Interest rate swaps assist the Corporation's Asset Liability Management ( 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.

Interest rate contracts, which are generally non-leveraged interest rate swaps, allow the Corporation to effectively manage its interest rate risk position. Non-leveraged interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments based on the contractual underlying notional amount. Exposure to loss on these contracts will increase or decrease over their respective lives as interest rates fluctuate.

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. In managing credit risk associated with its derivative activities, the Corporation deals primarily with commercial banks, broker-dealers and corporations. 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.

#### *Accrued Taxes*

The Corporation estimates tax expense based on the amount it is expected to owe various tax jurisdictions. The estimate of tax expense is reported in the **Consolidated Statements of Income**. Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions either currently or in the future and are reported as a component of accrued expenses and other liabilities on the **Consolidated Balance Sheet**. In estimating accrued taxes, the Corporation assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Corporation's tax position.

Changes to the estimate of accrued taxes occur periodically due to changes in the tax rates, implementation of new tax planning strategies, resolution with taxing authorities of issues with previously taken tax positions and newly enacted statutory, judicial and regulatory guidance. These changes, which are often driven by the Corporation's judgments, affect accrued taxes and can be material to the Corporation's operating results for any particular quarter.

#### *Recently Adopted Accounting Pronouncements*

In January 2003, the Financial Accounting Standards Board ( FASB ) issued Financial Accounting Standards Board Interpretation No. 46, ( FIN 46 ), Consolidation of Variable Interest Entities, which addresses consolidation of variable interest entities by business enterprises. Variable interest entities are entities with equity interests that do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of expected losses if they occur, receive a majority of the entity's residual returns if they occur, or both. The enterprise that consolidates the variable interest entity is called the primary beneficiary of that entity. Under FIN 46 an enterprise that holds significant variable interests in a variable interest entity, but is not the primary beneficiary, is required to disclose the nature, purpose, size, and activities of the variable interest entity, its exposure to loss as a result of the variable interest holder's involvement with the entity, and the nature of its involvement with the entity and date when the involvement began. The primary beneficiary of a variable interest entity is required to disclose the nature, purpose, size, and activities of the variable interest entity, the carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations, and any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary. In December 2003, the FASB issued a revision to FIN 46 ( FIN 46 R ), which clarifies and interprets certain provisions

of FIN 46, without changing the basic accounting model of FIN 46. The Corporation adopted the provisions of FIN 46 and FIN 46 R effective March 2004 with no material effect on its consolidated financial statements. At June 30, 2004, the Corporation did not have any significant investments in variable interest entities.

In March 2004, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 105 (SAB 105), which contains specific guidance on the inputs to a valuation-recognition model to measure loan

commitments accounted for at fair value. SAB 105 requires that fair-value measurement include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected future cash flows related to the customer relationship or loan servicing. SAB 105 is effective for mortgage-loan commitments that are accounted for as derivatives and are entered into after June 30, 2004. The Corporation adopted SAB 105 on June 30, 2004, with no 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.

## 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 and six months ended June 30, 2004 and 2003, 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, 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 June 30</b>		<b>Six Months Ended June 30</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Basic weighted average number of common shares outstanding	<b>29,763,619</b>	29,801,059	<b>29,765,952</b>	29,903,170
Dilutive effect arising from potential common stock issuances	<b>303,843</b>	_____	<b>295,577</b>	176,636
Diluted weighted average number of common shares outstanding	<b>30,067,462</b>	29,801,059	<b>30,061,529</b>	30,079,806

The effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per common share. These amounts were 1.0 million shares and 0.9 million shares for the three and six months ended June 30, 2004, respectively, and 1.7 million shares and 1.6 million shares for the comparable 2003 periods.

The Corporation paid cash dividends of \$0.185 per share for both the three months ended June 30, 2004 and 2003, respectively, and paid cash dividends of \$0.37 per share for both the six months ended June 30, 2004 and 2003, respectively.





**Note Three Business Segment Information**

Refer to the Corporation's Annual Report on Form 10-K for the year ended December 31, 2003 for information with respect to the Corporation's policies for defining and accounting for its segments. Financial information by segment for the six months ended June 30, 2004 and 2003 is as follows:

**June 30, 2004**

(Dollars in thousands)	FCB	Other Operating Segments (1)	Other (2)	Totals
<b>Total interest income</b>	\$ 89,823	\$ 273	\$ 40	\$ 90,136
<b>Total interest expense</b>	29,373		358	29,731
<b>Net interest income</b>	60,450	273	(318)	60,405
<b>Provision for loan losses</b>	5,000			5,000
<b>Total noninterest income</b>	17,101	11,637	817	29,555
<b>Total noninterest expense</b>	44,487	11,411	94	55,992
<b>Net income before income taxes</b>	28,064	499	405	28,968
<b>Income taxes expense</b>	9,178	162	133	9,473
<b>Net income</b>	\$ 18,886	\$ 337	\$ 272	\$ 19,495
<b>Total loans held for sale and loans, net</b>	\$2,321,188	\$ 27,566	\$	\$2,348,754
<b>Total assets</b>	4,245,618	73,706	19,889	4,339,213

**June 30, 2003**

(Dollars in thousands)	FCB	Other Operating Segments (1)	Other (2)	Totals
Total interest income	\$ 90,229	\$ 246	\$ 34	\$ 90,509
Total interest expense	37,604		283	37,887
Net interest income	52,625	246	(249)	52,622
Provision for loan losses	21,543			21,543
Total noninterest income	27,697	8,401	(279)	35,819
Total noninterest expense	50,222	8,828	36	59,086

Net income (loss) before income taxes	8,557	(181)	(564)	7,812
Income taxes expense (benefit)	2,267	(47)	(150)	2,070
Net income (loss)	\$ 6,290	\$ (134)	\$ (414)	\$ 5,742
Total loans held for sale and loans, net	\$2,039,061	\$ 47,065	\$	\$2,086,126
Total assets	3,903,577	59,304	25,653	3,988,534

(1) Included in Other Operating Segments are revenues, expenses and assets of insurance services, brokerage, mortgage and financial management.

(2) Included in Other are revenues, expenses and assets of the parent company and eliminations.

#### **Note Four - Acquisitions**

(a) *Insurance Agencies.* In July and October of 2003, the Corporation, through a subsidiary of FCB, acquired Piedmont Insurance Agency, Inc. and Robertson Insurance Agency, Inc., respectively. The purchase price for both agencies totaled \$1.1 million in cash and were accounted for as purchases. The purchase agreements also contemplate additional cash payments based on the post-closing performance of the acquired businesses. The year over year increases in insurance services income is due to the organic growth of our insurance agencies as well as the insurance agencies and customer lists acquired. Pro forma financial information reflecting the effect of these acquisitions on periods prior to the combination is not considered material.

(b) *Third Party Benefits Administrator.* In July of 2003, the Corporation, through a subsidiary of FCB, purchased a third party benefits administrator in a stock transaction. The purchase price delivered at closing consisted of First Charter common stock valued at \$1.32 million, and the agreement contemplates additional common stock payments based on the post closing performance of the business. The value of such additional payments, if earned, is expected to total approximately \$880,000. This acquisition was accounted for as a purchase. Accordingly, the results of operations of this entity are included in the consolidated results of operations of the Corporation from the

date of the acquisition. The year over year increases in financial management income is mainly due to the third party benefits administrator acquired. Pro forma financial information reflecting the effect of this acquisition on periods prior to the combination is not considered material. Intangible assets amounted to \$1.1 million from the acquisition.

#### Note Five - 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 June 30, 2004 and December 31, 2003:

(Dollars in thousands)	June 30 2004		December 31 2003	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Noncompete agreements <sup>(1)</sup>	\$ 946	\$ 906	\$ 946	\$ 861
Customer lists <sup>(1)</sup>	1,471	370	1,471	236
Mortgage servicing rights <sup>(1)</sup>	7,365	5,551	7,083	4,977
Branch acquisitions <sup>(2)</sup>	1,111	1,111	1,111	1,097
Other intangibles <sup>(1)(3)</sup>	232	44	232	22
<b>Total</b>	<b>\$11,125</b>	<b>\$ 7,982</b>	<b>\$10,843</b>	<b>\$ 7,193</b>
Unamortized intangible assets:				
Goodwill <sup>(4)</sup>	\$19,222	\$	\$19,222	\$

(1) Noncompete agreements, customer lists, mortgage servicing rights and other intangibles are recorded in the Other Operating Segments as described in the 2003 Annual Report on Form 10-K.

(2) Branch acquisition intangible assets are recorded in the FCB segment as described in the 2003 Annual Report on Form 10-K.

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

(4) Goodwill of \$6,278 is recorded in the Other Operating Segments and \$12,944 is recorded on FCB as described in the 2003 Annual Report on Form 10-K.

Amortization expense, excluding amortization of mortgage servicing rights, totaled \$96,000 and \$214,000 for the three and six months ended June 30, 2004, respectively, and \$77,000 and \$162,000 for the comparable 2003 periods.

The following table presents the estimated amortization expense for intangible assets for the years ended December 31, 2004, 2005, 2006, 2007, 2008 and 2009 and thereafter:

(Dollars in thousands)	Noncompetete Agreements	Customer Lists	Mortgage Servicing Rights	Branch Acquisitions	Other Intangibles	Total
2004	\$ 85	\$ 260	\$ 921	\$ 14	\$ 42	\$1,322
2005		226	482		37	745
2006		193	344		32	569
2007		160	248		28	436
2008		126	157		23	306
2009 and after		270	235		48	553
<b>Total</b>	<b>\$ 85</b>	<b>\$1,235</b>	<b>\$2,387</b>	<b>\$ 14</b>	<b>\$ 210</b>	<b>\$3,931</b>

**Note Six - Comprehensive Income (Loss)**

Comprehensive income (loss) includes net income and all non-owner changes to the Corporation's equity. The Corporation's only component of other comprehensive income (loss) is the change in unrealized gains and losses on available for sale securities.

The Corporation's total comprehensive loss for the six months ended June 30, 2004 was \$5.5 million compared to total comprehensive income for the six months ended June 30, 2003 of \$6.3 million. The after-tax unrealized loss on securities available for sale at June 30, 2004 was \$18.8 million compared to an after-tax unrealized gain of \$6.2 million at December 31, 2003. This decrease was due to an increase in interest rates across the yield curve. Information concerning the Corporation's other comprehensive income for the six months ended June 30, 2004 and 2003 is as follows:

(Dollars in thousands)	For the Six Months Ended June 30,					
	2004			2003		
	Before Tax Amount	Tax Effect	After Tax Amount	Before Tax Amount	Tax Effect	After Tax Amount
Unrealized (losses) gains on securities:						
Unrealized (losses) gains arising during period	<b>\$(40,123)</b>	<b>\$(15,646)</b>	<b>\$(24,477)</b>	\$10,366	\$4,035	\$6,331
Less: Reclassification for realized gains	<b>820</b>	<b>320</b>	<b>500</b>	9,512	3,710	5,802
Unrealized (losses) gains, net of reclassification	<b>\$(40,943)</b>	<b>\$(15,966)</b>	<b>\$(24,977)</b>	\$ 854	\$ 325	\$ 529
Other comprehensive (loss) income	<b>\$(40,943)</b>	<b>\$(15,966)</b>	<b>\$(24,977)</b>	\$ 854	\$ 325	\$ 529

**Note Seven - Trading Activity**

The Corporation engages in writing over-the-counter covered call options on specific fixed income securities in the available for sale portfolio. Under these agreements, the Corporation agrees to sell, upon election by the optionholder, a fixed income security at a fixed price. The Corporation receives a premium from the optionholder in exchange for writing the option contract. In addition, the Corporation records the write up or write down in the market value of the First Charter Option Plan Trust (the "OPT Plan") as a trading gain or loss. The OPT Plan is a tax-deferred capital accumulation plan. For more information concerning the OPT Plan, see Note Fourteen of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2003. For the three and six months ended June 30, 2004, the Corporation recognized trading losses of \$5,000 and trading income of \$0.1 million, respectively, which primarily consisted of the mark to market of the investments in the OPT Plan. There were no written covered call options outstanding at June 30, 2004 or at any time during the three and six months ended June 30, 2004. For the three and six months ended June 30, 2003, the Corporation recognized trading gains of \$0.4 million and \$1.6 million, respectively,

primarily from writing covered call options. There were no written covered call options outstanding at June 30, 2003. The highest written covered call options outstanding at any time during the six months ended June 30, 2003 were \$125.0 million.

**Note Eight - Derivatives**

The Corporation utilizes interest rate swap agreements to provide an exchange of interest payments computed on notional amounts that will offset any undesirable change in fair value resulting from market rate changes on designated hedged items. A swap agreement is a contract between two parties to exchange cash flows based on specified underlying notional amounts, assets and/or indices. The interest rate swap agreements utilized by the Corporation qualify for hedge accounting as fair value hedges.

The Corporation accounts for these interest rate swaps as a hedge of the fair value of the related FHLB advances. Accordingly, the Corporation records on a quarterly basis, in noninterest income, the net change in the fair value of the interest rate swap and the related FHLB advances (ineffectiveness), provided the criteria for hedge

accounting continues to be met. In the event such criteria are not met in a future period, the Corporation will only record changes in the fair value on the interest rate swap. For the six months ended June 30, 2004, the Corporation recognized a net gain of \$18,000 for the ineffective portion of the interest rate swaps. At June 30, 2004, the derivative hedging instruments were recorded at fair value in other assets. These instruments had a gross unrealized loss of \$5.8 million at June 30, 2004.

Information concerning the Corporation's derivative instruments for the six months ended June 30, 2004 is as follows:

<b>June 30, 2004</b>							
<b>(Dollars in thousands)</b>	<b>Notional Amount</b>	<b>Average Receive Rate</b>	<b>Average Pay Rate</b>	<b>Average Maturity in Years</b>	<b>Gross Unrealized</b>		
					<b>Gains</b>	<b>Losses</b>	<b>Ineffectiveness</b>
Fair Value Hedges:							
Interest rate swaps	\$ 222,000	5.16%	3.00%	5.86	\$ (5,795)		\$ 18

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 the first half of 2004, three of those agreements totaling \$90.0 million qualify for the short cut method assumption of no ineffectiveness; therefore, there was no impact on earnings during the six months ended June 30, 2004 from those interest rate swap agreements.

#### Note Nine - Securities Available for Sale

Securities available for sale at June 30, 2004 and December 31, 2003 are summarized as follows:

<b>June 30, 2004</b>				
<b>(Dollars in thousands)</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
US government obligations	\$ 54,696	\$ 424	\$ 1,291	\$ 53,829
US government agency obligations	612,552	1,416	11,448	602,520
Mortgage-backed securities	818,799	2,118	24,382	796,535
State, county, and municipal obligations	87,134	2,199	562	88,771
Equity securities	62,250	680		62,930
<b>Total</b>	<b>\$1,635,431</b>	<b>\$6,837</b>	<b>\$37,683</b>	<b>\$1,604,585</b>



<b>December 30, 2004</b>				
<b>(Dollars in thousands)</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
US government obligations	\$ 59,715	\$ 875	\$ 317	\$ 60,273
US government agency obligations	630,629	6,480	1,842	635,267
Mortgage-backed securities	771,440	6,613	6,896	771,157
State, county, and municipal obligations	69,425	3,662		73,087
Equity securities	60,594	1,522		62,116
<b>Total</b>	<b>\$1,591,803</b>	<b>\$19,152</b>	<b>\$9,055</b>	<b>\$1,601,900</b>

Securities with an aggregate carrying value of \$1.2 billion at June 30, 2004 were pledged to secure public deposits, securities sold under agreements to repurchase and FHLB borrowings. Proceeds from the sale of securities available for sale were \$38.0 million and \$846.5 million for the six months ended June 30, 2004 and 2003, respectively. Gross gains of \$1.1 million and gross losses of \$0.3 million were realized in the six months ended June 30, 2004. Gross gains of \$9.5 million were realized in the six months ended June 30, 2003.

At June 30, 2004, US government agency obligations of \$478.8 million were considered temporarily impaired. US government agency obligations are interest-bearing debt securities of the US government and US government agencies. Mortgage-backed securities of \$704.3 million were considered temporarily impaired at June 30, 2004. 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. Cash flow from the principal and interest payments on the underlying mortgages is used to pay off the bonds. 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. US government obligations of \$38.7 million were considered temporarily impaired at June 30, 2004. These obligations are securities issued by the US Treasury. State, county and municipal obligations of \$16.2 million were considered temporarily impaired at June 30, 2004. 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 interest rates across the yield curve.

### Temporarily Impaired Investments

As of June 30, 2004

(Dollars in thousands)	Less than 12 months		12 months or longer		Total	
Description of Securities:	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
US government obligations	\$ 38,665	\$ (1,291)	\$	\$	\$ 38,665	\$ (1,291)
US government agency obligations	407,176	(8,175)	71,625	(3,273)	478,801	(11,448)
Mortgage-backed securities	489,901	(14,459)	214,362	(9,923)	704,263	(24,382)
State, county and municipal obligations	16,221	(562)			16,221	(562)
<b>Total temporarily impaired securities</b>	<b>\$951,963</b>	<b>\$(24,487)</b>	<b>\$285,987</b>	<b>\$(13,196)</b>	<b>\$1,237,950</b>	<b>\$(37,683)</b>

Investments that are in a gross unrealized loss position include five US government obligations, thirty-five US agency securities, fifty-seven mortgage-backed securities and fourteen 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 1 year have an external credit rating of AAA.

### Note Ten - Loans and Loans Held for Sale

The Corporation's primary market area includes North Carolina, and predominately centers around the metropolitan (metro) region of Charlotte, North Carolina. From time to time, the Corporation purchases construction loans in other market areas through a correspondent relationship. At June 30, 2004, the majority of the total loan portfolio, as well as a substantial portion of the commercial and real estate loan portfolios, was to borrowers within this region. The diversity of the region's economic base provides a stable lending environment. No areas of significant concentrations of credit risk have been identified due to the economic diversity of the borrowers.

The following is a summary of the loan portfolio at June 30, 2004 and December 31, 2003:

<b>(Dollars in thousands)</b>	<b>June 30, 2004</b>		<b>December 31, 2003</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
Commercial real estate	\$ 768,637	32.7%	\$ 724,340	32.2%
Commercial non real estate	208,587	8.9	212,010	9.4
Construction	332,031	14.1	358,217	15.9
Mortgage	315,005	13.4	280,748	12.5
Consumer	276,236	11.8	284,448	12.6
Home equity	447,739	19.1	393,041	17.4
<b>Total</b>	<b>\$2,348,235</b>	<b>100.0%</b>	<b>\$2,252,804</b>	<b>100.0%</b>

Loans held for sale consists primarily of 15 and 30 year mortgages which the Corporation intends to sell as whole loans or to securitize to improve its liquidity position. Loans held for sale are carried at the lower of aggregate

cost or market. Loans held for sale were \$26.8 million and \$5.1 million at June 30, 2004 and December 31, 2003, respectively. Loans held for sale was impacted by originations, sales activity and securitizations, which is reflected in the **Consolidated Statement of Cash Flows**. No valuation allowance to reduce these loans to lower of cost or market was required at June 30, 2004 and December 31, 2003.

The following is a summary of the changes in the allowance for loan losses for the three and six months ended June 30, 2004 and 2003:

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
<b>Balance, beginning of period</b>	<b>\$25,736</b>	\$ 26,495	<b>\$25,607</b>	\$ 27,204
Provision for loan losses	<b>2,000</b>	19,492	<b>5,000</b>	21,543
Allowance related to loans sold		(20,236)	<b>(549)</b>	(20,783)
Charge-offs	<b>(2,472)</b>	(2,448)	<b>(5,054)</b>	(4,914)
Recoveries	<b>788</b>	341	<b>1,048</b>	594
Net charge-offs	<b>(1,684)</b>	(2,107)	<b>(4,006)</b>	(4,320)
<b>Balance, June 30</b>	<b>\$26,052</b>	\$ 23,644	<b>\$26,052</b>	\$ 23,644

The allowance for loan losses was \$26.1 million or 1.11 percent of gross loans at June 30, 2004 compared to \$25.6 million or 1.14 percent of gross loans at December 31, 2003. The allowance for loan losses as a percentage of loans decreased primarily due to the impact of improved asset quality trends on the historical loss factors used in the loan loss migration model. In addition, the allowance for loan losses was reduced by \$0.5 million due to the sale of nonaccruing and accruing higher risk mortgage loans and by net charge-offs of \$4.0 million. Net charge-offs were impacted by one \$0.6 million commercial loan recovery during the second quarter of 2004. These reductions were offset by an additional provision expense of \$5.0 million.

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.

(Dollars in thousands)	June 30 2004	December 31 2003
Nonaccrual loans	<b>\$12,533</b>	\$ 14,910
Other real estate owned	<b>6,159</b>	6,836

	_____	_____
<b>Total nonperforming assets</b>	<b>18,693</b>	21,746
	_____	_____
Loans 90 days or more past due and still accruing		21
	_____	_____
<b>Total nonperforming assets and loans 90 days or more past due and still accruing</b>	<b>\$18,693</b>	\$ 21,767
	_____	_____

The recorded investment in individually impaired loans was \$6.5 million (all of which were on nonaccrual status) and \$4.7 million (all of which were on nonaccrual status) at June 30, 2004 and December 31, 2003, respectively. The related allowance for loan losses on these loans was \$1.9 million and \$0.9 million at June 30, 2004 and December 31, 2003, respectively. The average recorded investment in impaired loans for the six months ended June 30, 2004 and 2003 was \$6.1 million and \$17.7 million, respectively.

#### **Note Eleven Stock Repurchase Program**

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 June 30, 2004, 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 six months ended June 30, 2004.

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 June 30, 2004, no shares had been repurchased under this authorization.

**Note Twelve - 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 pro forma impact on net income per share as if the fair value of stock-based compensation plans had been recorded as a component of compensation expense in the consolidated financial statements as of the date of grant of awards related to such plans, pursuant to the provisions of the Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation and Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment to FASB Statement No. 123, is disclosed as follows:

<b>(Dollars in thousands, except per share data)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net income (loss), as reported	<b>\$10,255</b>	\$ (4,204)	<b>\$19,495</b>	\$ 5,742
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<b>473</b>	703	<b>941</b>	1,468
Pro forma net income (loss)	<b>\$ 9,782</b>	\$ (4,907)	<b>\$18,554</b>	\$ 4,274
Earnings (loss) per share:				
Basic-as reported	<b>\$ 0.34</b>	\$ (0.14)	<b>\$ 0.65</b>	\$ 0.19
Basic-pro forma	<b>\$ 0.33</b>	\$ (0.16)	<b>\$ 0.62</b>	\$ 0.14
Diluted-as reported	<b>\$ 0.34</b>	\$ (0.14)	<b>\$ 0.65</b>	\$ 0.19
Diluted-pro forma	<b>\$ 0.33</b>	\$ (0.16)	<b>\$ 0.62</b>	\$ 0.14

The fair value of each option granted during the three and six months ended June 30, 2004 and 2003 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>

**2000 Omnibus Stock Option and Award Plan**

Dividend yield	<b>3.47%</b>	4.21%	<b>3.54%</b>	4.21%
Risk free interest rates	<b>3.84%</b>	3.44%	<b>4.03%</b>	4.09%
Expected lives	<b>8 years</b>	10 years	<b>8 years</b>	10 years
Volatility	<b>26%</b>	32%	<b>26%</b>	33%
Forfeiture rate	<b>2%</b>	0%	<b>2%</b>	0%

**Director Plan**

Dividend yield	<b>3.70%</b>	4.21%	<b>3.70%</b>	4.21%
Risk free interest rates	<b>4.05%</b>	3.46%	<b>4.05%</b>	3.94%
Expected lives	<b>10 years</b>	10 years	<b>10 years</b>	10 years
Volatility	<b>26%</b>	32%	<b>26%</b>	33%
Forfeiture rate	<b>0.5%</b>	0%	<b>0.5%</b>	0%

**1999 Employee Stock Purchase Plan**

Dividend yield	<b>3.76%</b>	4.21%	<b>3.76%</b>	4.21%
Risk free interest rates	<b>4.38%</b>	4.07%	<b>4.38%</b>	4.07%
Expected lives	<b>1 year</b>	1 year	<b>1 year</b>	1 year
Volatility	<b>23%</b>	33%	<b>23%</b>	33%
Forfeiture rate	<b>9%</b>	0%	<b>9%</b>	0%

### **Note Thirteen 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. 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 June 30, 2004, the Corporation's exposure to credit risk was represented by preapproved but unused lines of credit totaling \$345.8 million, loan commitments totaling \$411.6 million and standby letters of credit in an aggregate amount of \$8.7 million. Of the \$345.8 million of preapproved unused lines of credit, \$29.8 million were at fixed rates and \$316.0 million were at floating rates. Of the \$411.6 million of loan commitments, \$101.9 million were at fixed rates and \$309.7 million were at floating rates. Of the \$8.7 million of standby letters of credit, \$8.6 million expire in less than one year and \$0.1 million expire in one to three years. The fair value and carrying value at June 30, 2004 of standby letters of credit issued or modified during the three and six months ended June 30, 2004 were less than \$100,000. 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 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.

### **Note Fourteen 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 decided to upgrade its service offerings to include 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. Consequently, no commissions were paid to Mr. Godbold during the three months ended June 30, 2004. For the three months ended March 31, 2004, the Corporation received revenues of approximately \$1.6 million, which resulted in fees of \$239,000 to Impact and resulted in Impact paying commissions to GFA (and Mr. Godbold) of \$168,000. For the three and six months ended June 30, 2003, the Corporation received revenues of approximately \$1.9 million and \$3.5 million, respectively, which resulted in fees of \$274,000 and \$510,000, respectively, to Impact and resulted in Impact paying commissions to GFA (and Mr. Godbold) of \$192,000 and \$358,000, respectively.

#### **Note Fifteen Equity Method Investments**

The Corporation's equity method investments represent investments in venture capital limited partnerships. The Corporation's recognition of earnings or losses from an equity method investment is determined by the Corporation's share of the investee's earnings on a quarterly basis (or, in the case of some smaller investments, on an annual basis if there has been no significant change in values). These limited partnerships generally provide their financial information during the quarter after the end of a given period, and the Corporation's policy is to record its share of earnings or losses on these equity method investments in the quarter such information was received.

These limited partnerships record their investments in investee companies on a fair value basis, with changes in the underlying fair values being reflected as an adjustment to their earnings in the period such changes are determined. The earnings of these limited partnerships, and therefore the amount recorded on an equity-method basis by the Corporation, are impacted significantly by changes in the underlying value of the companies in which these limited partnerships invest. All of the companies in which these limited partnerships invest are privately held, and their market values are not readily available. Estimations of these values are made by the management of the limited partnerships and are reviewed by the Corporation's management for reasonableness. The assumptions in the valuation of these investments include the viability of the business model, the ability of the investee company to obtain alternative financing, the ability to generate revenues in future periods and other subjective factors. Given the inherent risks associated with this type of investment in the current economic environment, there can be no guarantee that there will not be widely varying gains or losses on these equity method investments in future periods. If management of the limited partnerships had made different assumptions about the valuation of these investments, the Corporation's financial position and results of operations could have differed materially.

At June 30, 2004 and December 31, 2003, the total book value of equity method investments was \$2.7 million and \$2.8 million, respectively, and is included in other assets on the consolidated balance sheet. Of the \$2.7 million, \$1.1 million represents investments in venture capital partnerships, which invest primarily in equity securities. The remaining \$1.6 million is invested in Small Business Investment Companies (SBICs), which make debt investments that qualify for the investment test under the Community Reinvestment Act. At June 30, 2004, the Corporation's remaining commitment to fund the equity method investments was \$2.2 million and represented commitments to venture funds that are SBICs. These remaining commitments have the option of being called in 2004.

## **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 our 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 adversely 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) decisions to change the business mix of the Corporation.

### **Overview**

The Corporation is a bank holding company established as a North Carolina Corporation in 1983, with one wholly-owned banking subsidiary, FCB. FCB, a North Carolina State Bank, is the successor entity to The Concord National Bank, which was established in 1888. The Corporation's principal executive offices are located in Charlotte, North Carolina. FCB is a full service bank and trust company with 54 financial centers, six insurance offices and 93 ATMs located in 18 counties throughout the piedmont and western half of North Carolina. As of June 30, 2004, the Corporation and its subsidiaries owned 36 financial center locations and leased 18 financial center locations and six insurance offices. The Corporation also leases and maintains operations in Reston, Virginia for the origination of real estate loans. These operations are conducted by First Charter of Virginia Realty Investments, Inc., which 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. In addition, the Corporation leases a facility in Winston-Salem, North Carolina for the operations of its third party benefits administrator.

The Corporation's primary market area is located within North Carolina and predominately centers around the metropolitan (metro) region of Charlotte, 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 insurance industries have shown the most growth. The unemployment rate for the Charlotte metro region decreased to 6.4 percent at June 30, 2004 from 6.9 percent at June 30, 2003. This is the result of structural changes taking place in

the economy of the region. The service industry is now the major employer, followed by wholesale and retail trade. While commercial real estate lending has not returned to the levels seen before the recession, activity in this sector has increased. During the later half of 2003, there was some speculative development and a steady stream of property acquisitions and expansions in the office, mixed use, retail and industrial sectors in North Carolina. There is also a large amount of textile manufacturing and warehouse space on the market in those areas of the state that have experienced a decline of manufacturing.

The Corporation's operations are divided into five primary lines of business: community banking, mortgage, brokerage, insurance, and financial management. Community banking includes the retail and commercial distribution network consisting of 54 branches, telephone banking and business relationship officers. Community banking provides a variety of depository accounts including interest bearing and non-interest bearing checking accounts, savings accounts, certificates of deposit and money market accounts. In addition, community banking offers a variety of loan products, including commercial, consumer, real estate and home equity loans. The bank also maintains 93 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. Mortgage lenders are located in the community bank branches and are available through the telephone bank. First Charter Brokerage Services, Inc. offers full service and discount brokerage, annuity sales and financial planning services through 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. Its primary lines of business include commercial and consumer property and casualty insurance, and group health and life insurance. The financial management business provides comprehensive financial planning, funds management, trust services, investments and record keeping services for companies and individuals throughout the United States.

The principal offices of the Corporation are located in the 230,000 square foot First Charter Center located at 10200 David Taylor Drive in Charlotte, North Carolina, which is owned by the Bank through its subsidiaries. The First Charter Center contains the corporate offices of the Corporation as well as all of the support departments for the Bank.

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 our 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.

Improving the net interest margin is critical to the Corporation's strategy to grow earnings. The Corporation has repositioned the balance sheet to be asset sensitive under a broad range of interest rate scenarios. This has been accomplished by managing the level of fixed-rate loans and focusing on variable-rate lending. The Corporation anticipates that a rising interest rate environment will be advantageous to the net interest margin due to the asset sensitive nature of the balance sheet. In addition, rising interest rates will increase the effective yields on mortgage-backed securities by decreasing the amortization of premiums due to slowing prepayment speeds. However, a rise in interest rates across the yield curve can negatively impact the securities available for sale portfolio by increasing the unrealized net losses within the portfolio. To mitigate the risk of rising interest rates on the securities available for sale portfolio, the Corporation has maintained a shorter average life in the securities held for sale portfolio. This will allow the Corporation to reinvest the proceeds of maturing securities into higher rate securities or fund loan growth in a rising interest rate environment. The average weighted life of our securities available for sale portfolio was 3.74 years at June 30, 2004.

Lowering funding costs is also essential to improve the net interest margin. The Corporation continues its focus on growing deposits balances and shifting funding to lower-cost sources. The Corporation's Checking Account Marketing Program ( CHAMP ) has facilitated a shift in funding sources from higher-cost retail certificates of deposit to lower-cost transaction based accounts. In addition, in 2003 the Corporation prepaid \$131 million in longer-term, fixed-rate Federal Home Loan Bank ( FHLB ) advances in order to improve the net interest margin, which has lowered interest expense.

Loan growth is a major focus of the Corporation. The lending environment continues to be challenging due to economic conditions. However, loan growth has recently begun to accelerate, particularly in home equity loans. Management believes the Corporation is positioned for future loan growth due to an increasing number of lending

opportunities.

Maintaining sound asset quality is another major focus for the Corporation. As a result of this focus and the initiatives taken in 2003 and in the first half of 2004, our asset quality ratios have improved significantly and remain strong as evidenced by our asset quality ratios. During the second quarter of 2003, the Corporation sold \$60.9 million in nonaccruing and accruing higher risk loans to improve the asset quality of the loan portfolio and by containing the financial risk of these loans. Additionally, the Corporation sold its \$11.7 million credit card portfolio in the first quarter of 2003. Similarly, in the first quarter of 2004, \$6.4 million in nonaccruing and accruing higher risk

mortgage loans were sold. These activities are expected to have a positive impact on earnings by reducing the credit risk profile of the Corporation and eliminating significant future collection costs. 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 deposit market share within its market area is approximately 3 percent, giving the Corporation the opportunity to attract potential customers from a larger pool. The Corporation's primary methods of competition are to provide exceptional customer service and to proactively market its products. The Corporation uses a quarterly independent survey of customers to review its level of customer service. For the second quarter of 2004, 83 percent of the customers surveyed reported that they were very satisfied with the service at First Charter, compared to the industry average of 54 percent satisfied. The Corporation's customer attrition ratio was 15 percent for the second quarter of 2004 and remains below the industry average of 23 percent, which allows for increased opportunities to expand relationships with our customers. Our main strategy for obtaining new customers is CHAMP, a disciplined proactive approach to attracting new accounts and customers. Its success has provided the Corporation with opportunities to develop new customer relationships, to generate additional fee income and to shift our funding mix towards lower-cost funding sources. To meet the convenience needs of existing and potential customers, the Corporation has upgraded five branches in the past 18 months, opened one new branch, 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 areas as both market and economic conditions warrant.

Another focus for the Corporation is growing fee income through other lines of business. These sources of income provide stability to our earnings with minimal credit risk and less exposure to interest rate risk than our community bank's traditional lines of business. In addressing this area of focus, the Corporation, through a subsidiary of FCB, acquired two insurance agencies during the third and fourth quarters of 2003, expanding the reach of our insurance services with businesses and individuals throughout the Charlotte metro region. In addition, the Corporation, through a subsidiary of FCB, acquired a third party benefits administrator, during the third quarter of 2003, which added new customers, expanded our product line and improved our technology platform. Also, during 2003 and early 2004, First Charter Brokerage Services, Inc. increased its number of licensed sales associates. As a result of these actions and the continued success of CHAMP, income from service charges, financial management services, brokerage services and insurance services experienced strong growth in the first half of 2004. The Corporation continuously reviews other opportunities for new products, new services and expansion as conditions warrant.

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 greater resources, broader geographic coverage and higher lending limits than the Corporation. However, the Corporation has the fourth largest deposit market share in the Charlotte metro region, which allows the Corporation to compete against both larger and smaller financial institutions.

## **Financial Summary**

Net income amounted to \$10.3 million, or \$0.34 per diluted share, for the three months ended June 30, 2004, compared to a net loss of \$4.2 million or \$0.14 per diluted share for the same period in 2003. Net income for the three months ended June 30, 2003 was impacted by a higher provision for loan losses primarily attributable to the sale of \$60.9 million of nonaccruing and accruing higher risk loans. During the second quarter of 2004, the Corporation's primary noninterest income lines of business continued to generate strong revenue growth compared to the second quarter of 2003, with financial management income up 217 percent, insurance services income up 18 percent, service charges up 14 percent and brokerage services income up 11 percent. In addition, the Corporation began to realize the benefits from the refinancing of fixed-term advances during 2003 and the results of certain asset-liability management

( ALM ) transactions entered into during the first quarter of 2004 as interest expense decreased \$4.2 million or 22 percent. Noninterest expense decreased \$5.3 million primarily due to \$7.4 million of prepayment costs associated with refinancing \$50 million in fixed-term advances in the second quarter of 2003 which did not recur in 2004. Income tax expense increased \$7.0 million due to an increase in projected taxable income relative to nontaxable adjustments.



For the six months ended June 30, 2004, net income amounted to \$19.5 million, or \$0.65 per diluted share, compared to net income of \$5.7 million or \$0.19 per diluted share for the same period in 2003. Net income for the six months ended June 30, 2003 were impacted by a higher provision for loan losses primarily attributable to the sale of \$60.9 million of nonaccruing and accruing higher risk loans. During the first six months of 2004, the Corporation's primary noninterest income lines of business continued to generate strong revenue growth compared to the first half of 2003, with financial management income up 186 percent, brokerage services income up 44 percent, insurance services income up 21 percent and service charges up 12 percent. In addition, the Corporation began to realize the benefits from the refinancing of fixed-term advances during 2003 and the results of certain ALM transactions entered into during the first quarter of 2004 as interest expense decreased \$8.2 million or 22 percent. Noninterest expense decreased \$3.0 million primarily due to \$7.4 million of prepayment costs associated with refinancing \$50 million in fixed-term advances in the second quarter of 2003 which did not recur in 2004, partially offset by higher salaries and employee benefits. Income tax expense increased \$7.4 million due to an increase in projected taxable income relative to nontaxable adjustments.

During the first half of 2004, the Corporation continued to experience strong core business fundamentals in the areas of deposits and customer satisfaction that have created continued momentum for 2004. The continued success of CHAMP resulted in 19,779 new checking accounts being opened during the first half of 2004. In addition, during the first half of 2004, core retail households increased by 7,797 for a total of 99,544 primarily due to the success of CHAMP. For the first half of 2004, customer satisfaction scores were 83 percent very satisfied, surpassing the Corporation's threshold of 75 percent.

**Table One**  
**Select Financial Data**

(Dollars in thousands, except per share amounts)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
<b>Income statement</b>				
Interest income	\$ 44,906	\$ 45,141	\$ 90,136	\$ 90,509
Interest expense	14,874	19,102	29,731	37,887
Net interest income	30,032	26,039	60,405	52,622
Provision for loan losses	2,000	19,492	5,000	21,543
Noninterest income	14,890	20,215	29,555	35,754
Noninterest expense	27,685	32,988	55,993	59,021
Income (loss) before income taxes	15,237	(6,226)	28,967	7,812
Income tax expense (benefit)	4,982	(2,022)	9,472	2,070
Net income (loss)	\$ 10,255	\$ (4,204)	\$ 19,495	\$ 5,742
<b>Per common share</b>				
Basic net income (loss)	\$ 0.34	\$ (0.14)	\$ 0.65	\$ 0.19
Diluted net income (loss)	0.34	(0.14)	0.65	0.19
Cash dividends declared	0.185	0.185	0.370	0.370
Period-end book value	9.53	10.55	9.53	10.55
Average shares outstanding basic	29,763,619	29,801,059	29,765,952	29,903,170
Average shares outstanding diluted	30,067,462	29,801,059	30,061,529	30,079,806
<b>Ratios</b>				
Return on average shareholders' equity <sup>(1)(2)</sup>	13.90%	(5.18)%	13.07%	3.56%
Return on average assets <sup>(1)(2)</sup>	0.96	(0.42)	0.92	0.30
Net interest margin <sup>(1)</sup>	3.06	2.92	3.12	3.03
Average loans to average deposits	91.82	86.51	92.55	87.60
Average equity to average assets <sup>(2)</sup>	6.87	8.18	7.03	8.36
Efficiency ratio <sup>(3)</sup>	61.66	85.65	62.13	73.72
Dividend payout	54.41	(132.14)	56.92	194.74
<b>Selected period end balances</b>				
Securities available for sale	\$ 1,604,585	\$ 1,518,918	\$ 1,604,585	\$ 1,518,918
Loans held for sale	26,768	45,311	26,768	45,311
Loans	2,348,235	2,064,668	2,348,235	2,064,668
Allowance for loan losses	26,052	23,644	26,052	23,644
Total assets	4,339,213	3,988,534	4,339,213	3,988,534

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Total deposits	<b>2,594,765</b>	2,558,549	<b>2,594,765</b>	2,558,549
Borrowings	<b>1,410,481</b>	1,076,595	<b>1,410,481</b>	1,076,595
Total liabilities	<b>4,055,432</b>	3,674,618	<b>4,055,432</b>	3,674,618
Total shareholders equity	<b>283,781</b>	313,916	<b>283,781</b>	313,916
<b>Selected average balances</b>				
Loans and loans held for sale	<b>2,339,435</b>	2,179,291	<b>2,306,505</b>	2,145,946
Earning assets	<b>3,995,390</b>	3,648,447	<b>3,940,172</b>	3,561,743
Total assets <sup>(2)</sup>	<b>4,316,360</b>	3,981,461	<b>4,263,381</b>	3,893,661
Total deposits	<b>2,547,909</b>	2,519,240	<b>2,492,291</b>	2,449,733
Borrowings	<b>1,424,556</b>	1,084,288	<b>1,427,342</b>	1,067,555
Total shareholders equity <sup>(2)</sup>	<b>296,699</b>	325,728	<b>299,848</b>	325,699

(1) Annualized

(2) Amounts and ratios for prior periods have been adjusted to correct a calculation error with respect to average balances.

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

## Critical Accounting Policies

The Corporation's accounting policies are fundamental to understanding management's discussion and analysis of financial condition and results of operations. The Corporation has identified the following critical accounting policies: allowance for loan losses, accrued taxes, derivative instruments and equity method investments. For more information on all of these critical accounting policies, please refer to pages 17 to 19 of the Corporation's Annual Report on form 10-K for the year ended December 31, 2003. An update to these policies is provided below.

### *Accrued Taxes*

The Corporation estimates tax expense based on the amount it is expected to owe various tax jurisdictions. The estimate of tax expense is reported in the **Consolidated Statements of Income**. Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions either currently or in the future and are reported as a component of accrued expenses and other liabilities on the **Consolidated Balance Sheet**. In estimating accrued taxes, the Corporation assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Corporation's tax position.

Changes to the estimate of accrued taxes occur periodically due to changes in the tax rates, implementation of new tax planning strategies, resolution with taxing authorities of issues with previously taken tax positions and newly enacted statutory, judicial and regulatory guidance. These changes affect accrued taxes and can be material to the Corporation's operating results for any particular quarter.

### *Derivative Instruments*

The Corporation enters into interest rate swap agreements to provide an exchange of interest payments computed on notional amounts that will offset any undesirable change in fair value resulting from market rate changes on designated hedged items.

The Corporation accounts for these interest rate swaps as a hedge of the fair value of the related FHLB advances. Accordingly, the Corporation records, in noninterest income, the net change in the fair value of the interest rate swap and the related FHLB advances, provided the criteria for hedge accounting continues to be met. In the event the criteria for hedge accounting are not met in a future period, the Corporation will cease recording the change in fair value of the FHLB advances and will amortize into earnings the then carrying value of the interest rate swap over the life of the hedged item.

The Corporation formally documents at inception all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various hedge transactions as required by Statement of Financial Accounting Standards No. 133. The Corporation will discontinue hedge accounting when it is determined that a derivative is not expected to be or has ceased to be highly effective as a hedge, and will reflect changes in fair value through the income statement. See **Asset-Liability Management and Interest Rate Risk** for further details regarding these interest rate swap agreements.

## 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 and six months ended June 30, 2004 and 2003 is presented in **Tables Two and Table Three**. 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 and six months ended June 30, 2004 and 2003 are analyzed in **Tables Four and Five**. 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 June 30, 2004, net interest income amounted to \$30.0 million, an increase of 15.3 percent from net interest income of \$26.0 million for the three months ended June 30, 2003. The increase in net interest income was mainly due to a \$4.2 million reduction in interest expense compared to the three months ended June 30, 2003. Net interest income for the six months ended June 30, 2004 increased to \$60.4 million or 14.8 percent from the net interest income of \$52.6 million for the same 2003 period. This increase was primarily due to an \$8.2 million reduction in interest expense compared to the first half of 2003. The decrease in interest expense for both the three and six months ended June 30, 2004 compared to the same 2003 periods, was due to a shift in funding sources from higher-cost retail certificates of deposit to lower-cost transaction based accounts, the benefits from the refinancing of \$50 million and \$81 million of fixed-term advances in the second quarter and fourth quarter of 2003, respectively, and the benefits from certain asset-liability management transactions entered into during the first half of 2004. Net interest income was also impacted by a \$0.2 million and a \$0.4 million decrease in interest income for the three and six months ended June 30, 2004, respectively, due mainly to lower yields on earning assets resulting from the continued effects of the low interest rate environment.

The net interest margin (tax adjusted net interest income divided by average interest-earning assets) increased 14 basis points to 3.06 percent and 9 basis points to 3.12 percent for the three and six months ended June 30, 2004, respectively, compared to 2.92 percent and 3.03 percent in the same 2003 periods. Rates paid on interest bearing liabilities declined faster than the rates earned on interest bearing assets. The primary objective of interest rate risk management is to minimize the effect that changes in interest rates have on the net interest margin while maintaining an appropriate interest rate risk profile.

Average interest earning assets increased \$346.9 million and \$378.4 million to \$4.00 billion and \$3.94 billion for the three and six months ended June 30, 2004, respectively, compared to the same 2003 periods. These increases were primarily due to a \$225.4 million and \$259.4 million increase in the Corporation's average securities available for sale during the three and six months ended June 30, 2004, respectively, resulting from the securitization of \$286.9 million of mortgage loans held for sale during 2003. Average interest earning assets also increased as a result of growth in the Corporation's average loans and loans held for sale portfolio, which increased \$160.1 million and \$160.6 million during the three and six months ended June 30, 2004, respectively, compared to the same 2003 periods. These increases were mainly due to growth in the construction, mortgage and home equity loan categories. The increases in average loans and loans held for sale was partially offset by the sale of \$60.9 million in nonaccruing and accruing higher risk loans during the second quarter of 2003, the sale of \$11.7 million of credit card loans in the first quarter of 2003, the mortgage loan securitizations and the sale of \$6.4 million of nonaccruing and accruing higher risk mortgage loans in the first quarter of 2004.

In addition to the increase in average interest earning assets, the Corporation experienced an increase in average interest bearing liabilities. Average other borrowings increased \$340.3 million and \$359.8 million for the three and six months ended June 30, 2004, respectively, compared to the same 2003 periods and were used to fund loan growth and securities purchases. In addition, average deposits increased \$28.7 million and \$42.6 million from the three and six months ended June 30, 2003, respectively. A major contributor to the decrease in interest expense was a shift in average deposits from higher-cost certificates of deposits to lower cost transaction based accounts. While certificates of deposits declined on average \$90.2 million and \$105.7 million for the three and six months ended June 30, 2004, respectively, noninterest bearing and other core deposit categories increased \$118.9 million and \$148.2 million, respectively, primarily due to the continued success of CHAMP.

The following table includes interest income on interest earning assets and related average yields, as well as interest expense on interest bearing liabilities and related average rates paid for the three months ended June 30, 2004 and 2003. In addition, the table includes the net interest margin. Average balances were calculated using daily balances.

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

(Dollars in thousands)	Second Quarter 2004			Second Quarter 2003		
	Average Balance	Interest Income/Expense	Average Yield/Rate Paid <sup>(6)</sup>	Average Balance	Interest Income/Expense	Average Yield/Rate Paid <sup>(6)</sup>
<b>Interest earning assets:</b>						
Loans and loans held for sale <sup>(1)(2)(3)</sup>	\$2,339,435	\$29,373	5.05%	\$2,179,291	\$30,593	5.63%
Securities - taxable	1,554,677	14,870	3.83	1,338,982	13,619	4.07
Securities - nontaxable	83,240	1,090	5.24	73,509	1,312	7.14
Federal funds sold	1,501	3	0.90	2,074	6	1.13
Interest bearing bank deposits	16,537	39	0.95	54,591	159	1.17
<b>Total earning assets<sup>(4)</sup></b>	<b>3,995,390</b>	<b>45,375</b>	<b>4.56</b>	<b>3,648,447</b>	<b>45,689</b>	<b>5.02</b>
Cash and due from banks	89,265			80,131		
Other assets <sup>(5)</sup>	231,705			252,883		
<b>Total assets<sup>(5)</sup></b>	<b>\$4,316,360</b>			<b>\$3,981,461</b>		
<b>Interest bearing liabilities:</b>						
Demand deposits	867,432	1,890	0.88	796,511	2,409	1.21
Savings deposits	123,318	82	0.27	120,581	152	0.50
Other time deposits	1,195,031	6,647	2.24	1,285,266	9,106	2.84
Other borrowings	1,424,556	6,255	1.77	1,084,288	7,435	2.75
<b>Total interest bearing liabilities</b>	<b>3,610,337</b>	<b>14,874</b>	<b>1.66</b>	<b>3,286,646</b>	<b>19,102</b>	<b>2.33</b>
Noninterest bearing sources:						
Noninterest bearing deposits	362,129			316,882		
Other liabilities <sup>(5)</sup>	47,195			52,205		
Shareholders' equity <sup>(5)</sup>	296,699			325,728		

	_____	_____	_____	_____	_____	_____
<b>Total liabilities and Shareholders equity<sup>(5)</sup></b>	<b>\$4,316,360</b>			<b>\$3,981,461</b>		
	_____	_____	_____	_____	_____	_____
Net interest spread			<b>2.90</b>			2.69
Impact of noninterest bearing sources			<b>0.16</b>			0.23
	_____	_____	_____	_____	_____	_____
<b>Net interest income/ net interest margin</b>		<b>\$30,501</b>	<b>3.06%</b>		<b>\$26,587</b>	<b>2.92%</b>
	_____	_____	_____	_____	_____	_____

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

(2) Average loan balances are shown net of unearned income.

(3) Includes amortization of deferred loan fees of approximately \$499 and \$429 for the second quarter of 2004 and 2003, respectively.

(4) 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 second quarter of 2004 and 2003. The adjustments made to convert to a taxable-equivalent basis were \$469 and \$548 for the second quarter of 2004 and 2003, respectively.

(5) Amounts for prior periods have been adjusted to correct a calculation error with respect to average balances.

(6) Annualized



The following table includes interest income on interest earning assets and related average yields, as well as interest expense on interest bearing liabilities and related average rates paid for the six months ended June 30, 2004 and 2003. In addition, the table includes the net interest margin. Average balances were calculated using daily balances.

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

(Dollars in thousands)	Six Months Ended June 30					
	2004			2003		
	Average Balance	Interest Income/Expense	Average Yield/Rate Paid <sup>(6)</sup>	Average Balance	Interest Income/Expense	Average Yield/Rate Paid <sup>(6)</sup>
<b>Interest earning assets:</b>						
Loans and loans held for sale <sup>(1)(2)(3)</sup>	\$2,306,505	\$58,664	5.11%	\$2,145,946	\$61,051	5.74%
Securities - taxable	1,536,058	30,100	3.92	1,279,184	27,616	4.32
Securities - nontaxable	77,942	2,259	5.80	75,374	2,689	7.14
Federal funds sold	1,450	6	0.88	2,140	11	1.03
Interest bearing bank deposits	18,217	83	0.91	59,099	339	1.16
<b>Total earning assets<sup>(4)</sup></b>	<b>3,940,172</b>	<b>91,112</b>	<b>4.64</b>	<b>3,561,743</b>	<b>91,706</b>	<b>5.18</b>
Cash and due from banks	87,224			81,923		
Other assets <sup>(5)</sup>	235,985			249,995		
<b>Total assets<sup>(5)</sup></b>	<b>\$4,263,381</b>			<b>\$3,893,661</b>		
<b>Interest bearing liabilities:</b>						
Demand deposits	828,291	3,120	0.76	726,919	3,922	1.09
Savings deposits	121,893	166	0.27	117,425	327	0.56
Other time deposits	1,195,295	13,458	2.26	1,300,950	18,883	2.93
Other borrowings	1,427,342	12,987	1.83	1,067,555	14,755	2.79
<b>Total interest bearing liabilities</b>	<b>3,572,821</b>	<b>29,731</b>	<b>1.67</b>	<b>3,212,849</b>	<b>37,887</b>	<b>2.38</b>
Noninterest bearing sources:						
Noninterest bearing deposits	346,812			304,439		

Other liabilities <sup>(5)</sup>	<b>43,900</b>			50,674		
Shareholders' equity <sup>(5)</sup>	<b>299,848</b>			325,699		
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
<b>Total liabilities and Shareholders' equity<sup>(5)</sup></b>	<b>\$4,263,381</b>			<b>\$3,893,661</b>		
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Net interest spread			<b>2.97</b>			2.80
Impact of noninterest bearing sources			<b>0.16</b>			0.23
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
<b>Net interest income/ yield on earning assets</b>		<b>\$61,381</b>	<b>3.12%</b>		<b>\$53,819</b>	<b>3.03%</b>
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

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

(2) Average loan balances are shown net of unearned income.

(3) Includes amortization of deferred loan fees of approximately \$1,170 and \$985 for the six months ended June 30, 2004 and 2003, respectively.

(4) 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 six months of 2004 and 2003. The adjustments made to convert to a taxable-equivalent basis were \$976 and \$1,197 for the six months ended June 30, 2004 and 2003, respectively.

(5) Amounts for prior periods have been adjusted to correct a calculation error with respect to average balances.

(6) Annualized

The following table presents the changes in net interest income between the three months ended June 30, 2004 and the three months ended June 30, 2003:

**Table Four**  
**Volume and Rate Variance Analysis**

(Dollars in thousands)	Three Months ended			
	June 30, 2004 versus June 30, 2003			
	Increase (Decrease) in Net Interest Income Due to Change in Rate and Volume <sup>(1)</sup>			
	2004 Income/ Expense	Rate	Volume	2003 Income/ Expense
<b>Interest income:</b>				
Loans and loans held for sale <sup>(2)</sup>	\$29,373	\$(3,349)	\$2,129	\$30,593
Securities - taxable	14,870	(877)	2,128	13,619
Securities - nontaxable <sup>(2)</sup>	1,090	(373)	151	1,312
Federal funds sold	3	(1)	(2)	6
Interest bearing bank deposits	39	(20)	(100)	159
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total interest income	<u>\$45,375</u>	<u>\$(4,620)</u>	<u>\$4,306</u>	<u>\$45,689</u>
<b>Interest expense:</b>				
Demand deposits	\$ 1,890	\$ (704)	\$ 185	\$ 2,409
Savings deposits	82	(73)	3	152
Other time deposits	6,647	(1,888)	(571)	9,106
Other borrowings	6,255	(3,093)	1,913	7,435
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total interest expense	<u>14,874</u>	<u>(5,758)</u>	<u>1,530</u>	<u>19,102</u>
Net interest income	<u>\$30,501</u>	<u>\$ 1,138</u>	<u>\$2,776</u>	<u>\$26,587</u>

<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.

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

The following table presents the changes in net interest income between the six months ended June 30, 2004 and the six months ended June 30, 2003:

**Table Five**  
**Volume and Rate Variance Analysis**

<b>(Dollars in thousands)</b>	<b>Six Months ended</b>			
	<b>June 30, 2004 versus June 30, 2003</b>			
	<b>Increase (Decrease) in Net Interest Income</b>			
	<b>Due to Change in Rate and Volume<sup>(1)</sup></b>			
	<b>2004 Income/ Expense</b>	<b>Rate</b>	<b>Volume</b>	<b>2003 Income/ Expense</b>
<b>Interest income:</b>				
Loans and loans held for sale <sup>(2)</sup>	\$58,664	\$ (6,713)	\$ 4,326	\$61,051
Securities - taxable	30,100	(2,806)	5,290	27,616
Securities - nontaxable <sup>(2)</sup>	2,259	(513)	83	2,689
Federal funds sold	6	(1)	(4)	11
Interest bearing bank deposits	83	(47)	(209)	339
	<hr/>	<hr/>	<hr/>	<hr/>
Total interest income	\$91,112	\$(10,080)	\$ 9,486	\$91,706
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Interest expense:</b>				
Demand deposits	\$ 3,120	\$ (1,266)	\$ 464	\$ 3,922
Savings deposits	166	(170)	9	327
Other time deposits	13,458	(4,063)	(1,362)	18,883
Other borrowings	12,987	(5,890)	4,122	14,755
	<hr/>	<hr/>	<hr/>	<hr/>
Total interest expense	29,731	(11,389)	3,233	37,887
	<hr/>	<hr/>	<hr/>	<hr/>
Net interest income	\$61,381	\$ 1,309	\$ 6,253	\$53,819
	<hr/>	<hr/>	<hr/>	<hr/>

(1) 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.

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

## 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 our various lines of business including brokerage, mortgage, insurance and financial management. In addition, the Corporation realizes gains from the sale of fixed-income and equity securities and income from our investment in Bank Owned Life Insurance.

Noninterest income decreased \$5.3 million, or 26.3 percent, to \$14.9 million for the three months ended June 30, 2004, compared to the same period in 2003. Gains on the sale of securities of \$0.5 million were recognized in the second quarter of 2004 compared to \$8.3 million for the same period in 2003, representing a decrease of \$7.8 million. In addition, trading gains of \$0.4 million were recognized in the second quarter of 2003. These decreases were partially offset by a \$1.1 million increase in financial management income primarily attributable to the acquisition of a third party benefits administrator in the third quarter of 2003, an \$0.8 million increase in service charges reflecting growth in checking accounts, a \$0.5 million increase in other noninterest income due to growth in ATM, debit card and other miscellaneous fees and a \$0.4 million increase in insurance services revenue resulting from organic growth as well as the acquisition of two insurance agencies in the third and fourth quarters of 2003.

For the six months ended June 30, 2004, noninterest income decreased \$6.2 million, or 17.3 percent, to \$29.6 million, compared to the same period in 2003. Gains on the sale of securities of \$0.8 million were recognized in the first half of 2004 compared to \$9.5 million for the same period in 2003, representing a decrease of \$8.7 million. Gains totaling \$2.2 million from the sale of the Corporation's credit card portfolio and \$1.6 million of trading gains were recognized in the first half of 2003. These decreases were partially offset by a \$2.0 million increase in financial management income primarily attributable to the acquisition of a third party benefits administrator in the third quarter of 2003, a \$1.3 million increase in service charges reflecting growth in checking accounts, a \$1.0 million increase in other noninterest income due to growth in ATM, debit card and other miscellaneous fees, a \$1.0 million increase in insurance services revenue resulting from the acquisition of two insurance agencies in the third and fourth quarters of 2003 as well as organic growth and a \$0.6 million increase in brokerage services income. In addition, gains of \$0.8 million were recognized on the sale of bank property in the first half of 2004.

The following table compares noninterest income for the three and six months ended June 30, 2004 and 2003.

**Table Six**  
**Noninterest Income**

(Dollars in thousands)	Three Months Ended June 30		Increase/(Decrease)		Six Months Ended June 30		Increase/(Decrease)	
	2004	2003	Amount	Percent	2004	2003	Amount	Percent
Service charges on deposit accounts	\$ 6,346	\$ 5,571	\$ 775	13.9%	\$11,951	\$10,701	\$ 1,250	11.7%
Financial management income	1,545	488	1,057	216.6	3,047	1,066	1,981	185.8
Gain on sale of securities	494	8,286	(7,792)	(94.0)	820	9,512	(8,692)	(91.4)
Gain on sale of credit card loan portfolio				NA		2,213	(2,213)	(100.0)
Loss from equity method investments	(76)	(276)	200	72.5	(300)	(376)	76	(20.2)

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Mortgage services income	<b>596</b>	643	(47)	(7.3)	<b>1,024</b>	1,284	(260)	(20.2)
Brokerage services income	<b>902</b>	812	90	11.1	<b>1,872</b>	1,298	574	44.2
Insurance services income	<b>2,634</b>	2,229	405	18.2	<b>5,665</b>	4,666	999	21.4
Trading (losses) gains	<b>(5)</b>	432	(437)	(101.2)	<b>104</b>	1,596	(1,492)	(93.5)
Bank owned life insurance	<b>847</b>	967	(120)	(12.4)	<b>1,697</b>	1,913	(216)	(11.3)
Gain on sale of property				NA	<b>777</b>		777	NA
Other	<b>1,607</b>	1,063	544	51.2	<b>2,898</b>	1,881	1,017	54.1
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total noninterest income</b>	<b>\$14,890</b>	\$20,215	\$(5,325)	(26.3)%	<b>\$29,555</b>	\$35,754	\$(6,199)	(17.3)%
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

### 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 totaled \$27.7 million for the three months ended June 30, 2004, a decrease of \$5.3 million or 16.1 percent compared to the same 2003 period. The decrease was due to \$7.4 million of prepayment costs associated with refinancing \$50 million in fixed-term advances, in the second quarter of 2003, which did not recur in

2004. In addition, professional fees decreased \$0.9 million primarily due to second quarter 2003 fees associated with the previously mentioned sale of \$60.9 million of nonaccruing and accruing higher risk loans. These decreases were partially offset by a \$1.8 million increase in salaries and employee benefits due to additional personnel, including the acquisition of a third party benefits administrator and two insurance agencies and increased incentive compensation accruals; a \$0.5 million increase in occupancy and equipment primarily due to the previously mentioned acquisitions and branch expansion; and a \$0.4 million increase in data processing primarily due to increased software maintenance costs.

For the six months ended June 30, 2004, noninterest expense totaled \$56.0 million, a decrease of \$3.0 million or 5.1 percent compared to the same 2003 period. The decrease was due to \$7.4 million of prepayment costs associated with refinancing \$50 million in fixed-term advances in the second quarter of 2003 which did not recur in 2004. This decrease was partially offset by a \$3.1 million increase in salaries and employee benefits due to additional personnel, including the acquisition of a third party benefits administrator and two insurance agencies and increased incentive compensation accruals; a \$0.6 million increase in data processing primarily due to increased software maintenance costs and a \$0.5 million increase in occupancy and equipment primarily due to the previously mentioned acquisitions and branch expansion.

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 62.1 percent for the six months ended June 30, 2004 compared to 73.7 percent for the six months ended June 30, 2003. The calculation of the efficiency ratio excludes gains on sale of securities of \$0.8 million and \$9.5 million for the six months ended June 30, 2004 and 2003, respectively.

The following table compares noninterest expense for the three and six months ended June 30, 2004 and 2003.

**Table Seven**  
**Noninterest Expense**

(Dollars in thousands)	Three Months Ended June 30		Increase/(Decrease)		Six Months Ended June 30		Increase/(Decrease)	
	2004	2003	Amount	Percent	2004	2003	Amount	Percent
Salaries and employee benefits	\$14,368	\$12,585	\$ 1,783	14.2%	\$29,391	\$26,311	\$ 3,080	11.7%
Occupancy and equipment	4,379	3,913	466	11.9	8,616	8,079	537	6.6
Data processing	1,006	634	372	58.7	1,868	1,312	556	42.4
Marketing	1,126	1,161	(35)	(3.0)	2,244	2,314	(70)	(3.0)
Postage and supplies	1,306	1,152	154	13.4	2,577	2,288	289	12.6
Professional services	2,361	3,230	(869)	(26.9)	5,073	5,002	71	1.4
Telephone	507	513	(6)	(1.2)	1,001	1,116	(115)	(10.3)
Amortization of intangibles	96	77	19	24.7	214	162	52	32.1
Prepayment costs on borrowings		7,366	(7,366)	(100.0)		7,366	(7,366)	(100.0)
Other	2,536	2,357	179	7.6	5,009	5,071	(62)	(1.2)



<b>Total noninterest expense</b>	<b>\$27,685</b>	\$32,988	\$(5,303)	(16.1)%	<b>\$55,993</b>	\$59,021	\$(3,028)	(5.1)%
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

### Income Tax Expense

Total income tax expense for the second quarter of 2004 was \$5.0 million for an effective tax rate of 32.7 percent, compared to a tax benefit of \$2.0 million for an effective tax rate of 32.5 percent for the second quarter of 2003. The income tax expense for the six months ended June 30, 2004 amounted to \$9.5 million for an effective tax rate of 32.7 percent compared to \$2.1 million for an effective tax rate of 26.5 percent for the same 2003 period. The increase in the effective tax rate for 2004 was primarily due to an increase in projected taxable income relative to nontaxable adjustments. Management anticipates the 2004 effective tax rate to range from 31 to 33 percent. The Corporation's North Carolina tax returns for 1999, 2000 and 2001, are currently undergoing an audit by the North Carolina Department of Revenue. Management does not expect any significant, adverse impact to its results of operations arising from this examination.

### Business Segments

The Corporation's operations are divided into five operating segments: commercial banking, brokerage, insurance, mortgage and financial management. These segments are identified based on the Corporation's organizational structure and the Corporation's chief operating decision makers review separate results of operations for each of these operating segments. For purposes of segment reporting, the Corporation has only one reportable

segment, FCB, the Corporation's primary banking subsidiary. FCB provides businesses and individuals with commercial loans, retail loans, and deposit banking services. Brokerage, insurance, mortgage and financial management are reported as Other Operating Segments. Of these segments, the results of operations of FCB constitute a substantial majority of the consolidated net income, revenues and assets of the Corporation, as set forth in *Note Three* to the consolidated financial statements. Included in Other are revenue, expenses and assets of the parent company and eliminations.

The following table compares total income for the six months ended June 30, 2004 and 2003 for FCB, Other Operating Segments and Other:

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

(Dollars in thousands)	For the Six Months Ended June 30	
	2004	2003
FCB	\$18,886	\$6,290
Other Operating Segments	337	(134)
Other	272	(414)
Total consolidated	\$19,495	\$5,742

FCB's net income was \$18.9 million for the six months ended June 30, 2004 compared to \$6.3 million for the same year ago period. The increase was primarily due to (i) a \$16.5 million decrease in the provision for loan losses primarily attributable to the sale of \$60.9 million of nonaccruing and accruing higher risk loans in the second quarter of 2003; (ii) an \$8.2 million decrease in interest expense resulting from a shift in funding sources from higher-cost retail certificates of deposit to lower-cost transaction based accounts, the benefits from the refinancing of \$50 million and \$81 million of fixed-term advances in the second quarter and fourth quarter of 2003, respectively, and the benefits from certain ALM transactions entered into during the first half of 2004 and (iii) a \$5.7 million decrease in noninterest expense due to \$7.4 million of prepayment costs associated with refinancing \$50 million in fixed-term advances in the second quarter of 2003 which did not recur in 2004. These items were partially offset by (i) a \$10.6 million decrease in noninterest income which was comprised of recognition of the gain on the sale of the credit card portfolio in the first quarter of 2003, lower trading gains and a decrease in gains on the sale of securities, which was partially offset by a gain on the sale of properties, increased service charges and other noninterest income; (ii) a \$6.9 million increase in income tax expense due to an increase in projected taxable income relative to nontaxable adjustments and (iii) a \$0.4 million decrease in interest income due mainly to lower yields on earning assets resulting from the continued effects of the low interest rate environment.

Other operating segments reported net income of \$0.3 million for the six months ended June 30, 2004 compared to a net loss of \$0.1 million for the same year ago period. The increase was attributable to higher noninterest income of \$3.2 million due to increases in financial management income, insurance services revenues and brokerage services revenues. The increases were partially offset by increased noninterest expense of \$2.6 million resulting from an

increase in salaries and employee benefits due to additional personnel, including the acquisition of a third party benefits administrator and two insurance agencies, and increased incentive compensation accruals based on the increases in noninterest income. These changes resulted in tax expense of \$0.2 million for the first half of 2004, compared to a tax benefit of \$47,000 for the same year ago period.

### **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 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 June 30, 2004, securities available for sale were \$1.604 billion or 37.0 percent of total assets, compared to \$1.602 billion or 38.1 percent of total assets at December 31, 2003. The securities available for sale portfolio was impacted by an increase in the unrealized net losses in the portfolio due to a rise in interest rates across the yield curve. Unrealized net losses on securities available for sale were \$30.8 million at June 30, 2004 compared to unrealized net gains of \$10.1 million at December 31, 2003. The decrease in the securities available for sale portfolio was partially offset by the securitization of \$21.3 million of residential mortgage loans during the second quarter.

Proceeds from the sale of securities available for sale were \$38.0 million and \$846.5 million for the six months ended June 30, 2004 and 2003, respectively. Gross gains of \$1.1 million and gross losses of \$0.3 million were realized in the six months ended June 30, 2004. Gross gains of \$9.5 million were realized in the six months ended June 30, 2003.

With market indicators predicting a rise in interest rates, the unrealized net losses in the securities available for sale portfolio could increase. However, the effective yields in the portfolio would increase as the amortization of premiums decreases due to slowing prepayment speeds. To mitigate the risk of rising interest rates on the securities available for sale portfolio, the Corporation has maintained a shortened average life in the securities held for sale portfolio over the past two years. This will allow the Corporation to reinvest the proceeds of maturing securities into higher rate securities or fund loan growth in a rising interest rate environment.

The weighted average life of the portfolio was 3.74 years at June 30, 2004 compared to 3.66 years at December 31, 2003.

### **Loans Held for Sale**

Loans held for sale consists primarily of 15 and 30 year mortgages which the Corporation intends to sell as whole loans to improve its liquidity position. Loans held for sale are carried at the lower of aggregate cost or market. Loans held for sale were \$26.8 million and \$5.1 million at June 30, 2004 and December 31, 2003, respectively. Loans held for sale was impacted by originations, sales activity and securitizations, which is reflected in the **Consolidated Statement of Cash Flows**. No valuation allowance to reduce these loans to lower of cost or market was required at June 30, 2004 and December 31, 2003.

### **Loan Portfolio**

The Corporation's loan portfolio at June 30, 2004 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 our 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 these loan categories. The Corporation's loans are generally five years or less in duration 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, both participations and syndications, from key strategic partner financial institutions with which the Corporation has established relationships. Current balances of loans purchased and sold through the strategic partners program were \$215.1 million and \$15.3 million, respectively, at June 30, 2004. 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 by competition, is usually tied to widely recognized market indexes, such as the prime rate, the London Interbank Offer Rate (LIBOR) or rates on US 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 US 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 June 30, 2004 loans purchased through this relationship represented 33.8 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 Reston, Virginia, which is a loan origination office. The Corporation offers a full line of products, including conventional, conforming, and jumbo fixed-rate and adjustable rate mortgages which are originated and sold into the secondary market; however, from time to time a portion of this production is retained and are serviced by the Corporation.

### *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. All consumer lending is centrally decided and documented.

### *Home Equity*

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

Gross loans increased \$95.4 million to \$2.35 billion at June 30, 2004 compared to \$2.25 billion at December 31, 2003. The growth in loans was primarily due to a \$54.7 million increase in home equity loans partially due to the Corporation's direct mailing campaign, a \$44.3 million increase in commercial real estate loans, and a \$34.3 million increase in primarily adjustable rate mortgage loans. These increases were partially offset by a \$26.2 million and an \$8.2 million decrease in construction and consumer loans, respectively. In addition, \$6.4 million of nonaccruing and accruing higher risk residential mortgage loans were sold to investors during the first quarter of 2004 and

\$45.7 million of primarily fixed-rate mortgage loans originated in the first half of 2004 were classified as held for sale.

The mix of variable and fixed-rate loans is a part of the Corporation's ALM strategy. As of June 30, 2004, approximately \$1.5 billion of the \$2.35 billion loan portfolio was tied to variable interest rates.

The table below summarizes loans in the classifications indicated as of June 30, 2004, and December 31, 2003.

**Table Nine**  
**Loan Portfolio Composition**

(Dollars in thousands)	June 30, 2004	% of Total Loans	December 31, 2003	% of Total Loans
Commercial real estate	\$ 768,637	32.74%	\$ 724,340	32.15%
Commercial non real estate	208,587	8.88	212,010	9.41
Construction	332,031	14.14	358,217	15.90
Mortgage	315,005	13.41	280,748	12.46
Consumer	276,236	11.76	284,448	12.63
Home equity	447,739	19.07	393,041	17.45
<b>Total loans</b>	<b>2,348,235</b>	<b>100.00</b>	<b>2,252,804</b>	<b>100.00</b>
Less allowance for loan losses	(26,052)	(1.11)	(25,607)	(1.14)
Unearned income	(197)	(0.01)	(167)	(0.01)
<b>Loans, net</b>	<b>\$2,321,986</b>	<b>98.88%</b>	<b>\$2,227,030</b>	<b>98.85%</b>

### Deposits

CHAMP continues to attract new customers and deposits. During the first half of 2004, 19,779 new checking accounts were opened. In addition, during the first quarter of 2004 the Corporation introduced a new money market account, the Performance Plus Account, which offers an above market introductory interest rate for the first 90 days after an account is opened. This product has generated \$228.0 million of deposits as of June 30, 2004. The emphasis of these programs is to develop new customer relationships, to shift our funding mix towards lower-cost funding sources and to generate additional fee income opportunities.

Total deposits increased \$166.9 million to \$2.59 billion at June 30, 2004 compared to \$2.43 billion at December 31, 2003. The increase in deposits was due to a \$93.0 million increase in money market accounts and a \$52.5 million increase in low-cost interest checking, savings and noninterest bearing deposits. Also, as a result of the Corporation's strategy of shifting the funding mix, lower-cost brokered certificates of deposit increased \$65.6 million, while higher-cost retail certificates of deposit decreased \$44.2 million. *Tables Two and Three* provide information on the average deposit balances for the three and six months ended June 30, 2004 and 2003, respectively.

### Other Borrowings

Other borrowings consist of Federal Funds purchased, securities sold under agreement to repurchase, FHLB



borrowings and other miscellaneous borrowings. Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. Securities sold under agreements to repurchase represent short-term borrowings by the Bank with maturities less than one year collateralized by a portion of the Corporation's securities of the United States government or its agencies. 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 decreased to \$1.41 billion at June 30, 2004 compared to \$1.43 billion at December 31, 2003.

### **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. Lastly, 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 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 loans less than \$500,000 may be approved by experienced loan officers, within their loan authority. Commercial and commercial real estate loans are approved by signature authority requiring at least two experienced lenders for any relationships greater than \$500,000 and an independent Risk Manager whenever the relationship is greater than \$1 million. All relationships greater than \$2.0 million receive a comprehensive annual review by the senior lending officers of the Bank, which is then reviewed by the independent Risk Management Officers and 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 million per relationship; however, at times some loans may exceed that limit. As of June 30, 2004, the Corporation had 12 relationships with exposure greater than the \$10 million lending limit. At June 30, 2004, the total loan balance of these relationships was \$126.0 million, all of which were current, with unfunded commitments totaling \$56.7 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, 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. This process is 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 June 30, 2004, 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 our primary market area could adversely affect our business. The diversity of the region's economic base tends to provide a stable lending environment. 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. In managing credit risk associated with its derivative activities, the Corporation deals primarily with commercial banks, broker-dealers and corporations. 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 the first half of 2004, the Corporation entered into a series of interest rate swap agreements to provide an exchange of interest payments computed on notional amounts that will offset any undesirable change in fair value resulting from market rate changes on designated hedged items. 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 June 30, 2004 decreased to \$12.5 million compared to \$14.9 million at December 31, 2003. The decrease includes the sale of \$2.1 million of nonaccrual mortgage loans during the first quarter of 2004. OREO decreased to \$6.2 million at June 30, 2004 from \$6.8 million at December 31, 2003.

As a result of the Corporation's continued focus on asset quality and the initiatives taken in 2003 and in the first half of 2004, our asset quality ratios remain 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 Ten**  
**Nonperforming and Problem Assets**

(Dollars in thousands)	June 30 2004	March 31 2004	December 31 2003	September 30 2003	June 30 2003
Nonaccrual loans	<b>\$12,533</b>	\$11,845	\$14,910	\$13,398	\$11,144
Other real estate owned	<b>6,159</b>	6,199	6,836	6,709	6,866
<b>Total nonperforming assets</b>	<b>18,693</b>	18,044	21,746	20,107	18,010
Loans 90 days or more past due and still accruing interest			21	21	312
<b>Total nonperforming assets and loans 90 days or more past due and still accruing interest</b>	<b>\$18,693</b>	\$18,044	\$21,767	\$20,128	\$18,322

Nonperforming assets as a percentage of:

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Total assets	<b>0.43%</b>	0.42%	0.52%	0.49%	0.45%
Total loans and other real estate owned	<b>0.79</b>	0.79	0.96	0.95	0.87
Past due loans over 30 days as a percentage of loans	<b>0.47</b>	0.64	1.04	0.71	0.67
Nonaccrual loans as a percentage of loans	<b>0.53</b>	0.52	0.66	0.64	0.54
Ratio of allowance for loan losses to nonperforming loans	<b>2.08x</b>	2.17x	1.72x	1.79x	2.12x

Nonaccrual loans at June 30, 2004 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 estimating the allowance for loan losses. See **Allowance for Loan Losses** for a more detailed discussion.

The determination to discontinue the accrual of interest is based on a review of each loan. Generally, accrual of interest is discontinued on loans 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. 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 considered 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.

The table below presents certain data for the three and six months ended June 30, 2004 and 2003, 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 June 30, 2004 and 2003, (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 June 30, 2004 and 2003.

**Table Eleven**  
**Allowance For Loan Losses**

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
<b>Balance, beginning of period</b>	<u>\$ 25,736</u>	<u>\$ 26,495</u>	<u>\$ 25,607</u>	<u>\$ 27,204</u>
<b>Loan charge-offs:</b>				
Commercial non real estate	288	1,406	553	2,975
Commercial real estate	1,059	194	2,094	406
Construction		(41)		(41)
Mortgage			29	5
Consumer	850	694	1,705	1,290
Home equity	275	195	673	279
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total loans charged-off</b>	<u>2,472</u>	<u>2,448</u>	<u>5,054</u>	<u>4,914</u>
<b>Recoveries of loans previously charged-off:</b>				
Commercial non real estate	638	267	664	358

Commercial real estate				1
Consumer	<b>150</b>	69	<b>384</b>	202
Other		5		33
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total recoveries of loans previously charged-off	<b>788</b>	341	<b>1,048</b>	594
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net charge-offs	<b>1,684</b>	2,107	<b>4,006</b>	4,320
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Provision for loan losses	<b>2,000</b>	19,492	<b>5,000</b>	21,543
Allowance related to loans sold		(20,236)	<b>(549)</b>	(20,783)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Balance, June 30</b>	<b>\$ 26,052</b>	\$ 23,644	<b>\$ 26,052</b>	\$ 23,644
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Average loans	<b>\$2,319,945</b>	\$2,140,412	<b>\$2,295,854</b>	\$2,122,314
Net charge-offs to average loans (annualized)	<b>0.29%</b>	0.39%	<b>0.35%</b>	0.41%
Allowance for loan losses to gross loans	<b>1.11</b>	1.15	<b>1.11</b>	1.15
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

The allowance for loan losses was \$26.1 million or 1.11 percent of gross loans at June 30, 2004 compared to \$25.6 million or 1.14 percent of gross loans at December 31, 2003. The allowance for loan losses as a percentage of loans decreased primarily due to the impact of improved asset quality trends on the historical loss factors used in the loan loss migration model. In addition, the allowance for loan losses was reduced by \$0.5 million due to the sale of nonaccruing and accruing higher risk mortgage loans and by net charge-offs of \$4.0 million. Net charge-offs were impacted by one \$0.6 million commercial loan recovery during the second quarter of 2004. These reductions were offset by an additional provision expense of \$5.0 million.

The allowance for loan losses was also impacted by changes in the allocation of loan losses to various loan types. Total commercial loan allocations decreased \$0.3 million primarily due to decreases in the historical loss factors as asset quality trends improved. As a result of the previously mentioned sale of \$60.9 million of nonaccruing and accruing higher risk loans in the second quarter of 2003, the historical loss factors in the allowance model increased. As the asset quality in the commercial loan portfolio improves, the historical loss factors continue to decrease. Management anticipates the historical loss factors to continue to trend lower over time, as the allowance model will be impacted by lower historical losses. Mortgage loan allocations of allowance increased \$0.1 million during the first half of 2004 primarily due to mortgage loan growth, partially offset by the sale of nonaccruing and accruing higher risk mortgage loans. Consumer loan allocation factors increased \$0.8 million primarily due to increases in the consumer historical loss factors used in the allowance model.

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 of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the recognition of adjustments to the allowance 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 \$2.0 million for the three months ended June 30, 2004 compared to \$19.5 million for the same year ago period. The provision for loan losses for the six months ended June 30, 2004, decreased to \$5.0 million compared to \$21.5 million for the same year ago period. The decrease in the provision for loan losses was primarily attributable to the previously mentioned sale of \$60.9 million of nonaccruing and accruing higher risk loans in the second quarter of 2003. In addition, certain residential rental property loans totaling \$12.9 million identified in the second quarter of 2003 resulted in the Corporation increasing the provision for loan losses by approximately \$2.4 million during that period. At June 30, 2004, there were 115 of these loans remaining with a balance of \$7.6 million.

The provision for loan losses was also impacted by a decrease in net charge-offs of \$0.4 million and \$0.3 million for the three and six months ended June 30, 2004, compared to the same year ago period. This decrease was primarily



due to a \$0.6 million commercial loan recovery during the second quarter of 2004. Net charge-offs for the three months ended June 30, 2004 amounted to \$1.7 million, or 0.29 percent of average loans, compared to \$2.1 million, or 0.39 percent of average loans for the same 2003 period. Net charge-offs for the six months ended June 30, 2004 amounted to \$4.0 million, or 0.35 percent of average loans, compared to \$4.3 million, or 0.41 percent of average loans for the same 2003 period.

During the first half of 2004, 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 June 30, 2004, 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 also continuously reviews its portfolio for any concentrations of loans to any one borrower or industry in the area. 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. Additional reserves have been set-aside in the allowance model for operational risk due to the differences in underwriting methodologies underlying the loans inherited through mergers. With the implementation of one central loan policy and procedure, this risk appears to be stable. As a result, the percent of additional allocation for the operational reserve has not changed in recent periods.

## **Market Risk Management**

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

The primary objective of the Corporation's asset-liability management strategy is to enhance earnings through balance sheet growth while reducing or minimizing the risk caused by interest rate changes. 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 or market value. 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 5.9 percent of net interest income at June 30, 2004. Assuming a 125 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 1.4 percent of net interest income at June 30, 2004. 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 the decreased interest rate shock scenario is equal to the Fed Funds rate of 125 basis points. Both of the rate shock scenarios are within Management's acceptable range.

In the first half of 2004, the Corporation entered into a series of interest rate swap agreements. The interest rate swaps will result in the Corporation receiving interest at an average fixed-rate of 5.16 percent and paying interest at an average variable-rate of 3.00 percent, which is based off LIBOR, for an average period of 5.9 years with a notional amount of \$222 million.

The Corporation accounts for these interest rate swaps as a hedge of the fair value of the related FHLB advances. Accordingly, the Corporation records on a quarterly basis, in earnings, the net change in the fair value of the interest rate swap and the related FHLB advances, provided the criteria for hedge accounting continue to be met. In the event such criteria are not met in a future period, the Corporation will only record changes in the fair value on the interest

rate swap.

As a result of swapping \$222 million of fixed-rate debt payments for variable-rate payments, the Corporation's balance sheet would become liability sensitive. Therefore, as part of the Corporation's ALM strategy of preserving the asset sensitive nature of the Corporation's balance sheet, the Corporation replaced \$255 million of existing FHLB floating rate overnight borrowings with fixed-rate FHLB advances with maturities of one to three years.

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.

Interest rate contracts, which are generally non-leveraged interest rate swaps, allow the Corporation to effectively manage its interest rate risk position. Non-leveraged interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments based on the contractual underlying notional amount. Exposure to loss on these contracts will increase or decrease over their respective lives as interest rates fluctuate.

Refer to *Note Seven* of the consolidated financial statements for a discussion of the Corporation's use of written over-the-counter covered call options.

*Table Twelve* 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 Twelve* 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 June 30, 2004. 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 Twelve**  
**Market Risk**  
**June 30, 2004**

(Dollars in thousands)	Total	Expected Maturity					
		1 Year	2 Years	3 Years	4 Years	5 Years	Thereafter
<b>Assets</b>							
Debt securities							
<i>Fixed rate</i>							
Book value	\$ 1,658,381	\$472,991	\$327,990	\$226,581	\$189,239	\$399,504	\$ 42,076
Weighted average effective yield	3.75%						
Fair value	\$ 1,541,655						
Loans and loans held for sale							
<i>Fixed rate</i>							
Book value	\$ 605,175	181,323	132,577	113,613	64,029	39,671	73,962
Weighted average effective yield	6.65%						
Fair value	\$ 616,329						
<i>Variable rate</i>							
Book value	\$ 1,743,579	628,951	253,963	191,567	125,124	88,327	455,647
Weighted average effective yield	4.62%						
Fair value	\$ 1,738,482						
<b>Liabilities</b>							
Deposits							
<i>Fixed rate</i>							
Book value	\$ 1,211,554	931,783	183,212	69,548	21,223	1,654	4,134
Weighted average effective yield	2.16%						
Fair value	\$ 1,215,310						
<i>Variable rate</i>							
Book value	\$ 1,014,473	264,596	261,076	259,794	111,402	55,561	62,044
Weighted average effective yield	0.49%						
Fair value	\$ 996,461						
Other borrowings							
<i>Fixed rate</i>							
Book value	\$ 697,267	235,046	125,054	135,057	60	63	201,987
Weighted average effective yield	3.13%						
Fair value	\$ 703,985						
<i>Variable rate</i>							
Book value	\$ 713,214	713,214					
	1.39%						

Weighted average  
effective yield  
Fair value                      \$ 713,186

**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 Thirteen* of the consolidated financial statements for further discussion of these 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 Thirteen**  
**Commitments**  
**As of June 30, 2004**

(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	\$ 29,064	\$ 2,679	\$ 3,275	\$310,827	\$345,845
Standby Letters of Credit	8,547	137			8,684
Loan Commitments	343,908	40,054	15,515	12,150	411,627
<b>Total Commitments</b>	<b>\$381,519</b>	<b>\$42,870</b>	<b>\$18,790</b>	<b>\$322,977</b>	<b>\$766,156</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 is to maximize net interest income while continuing to provide adequate liquidity to meet continuing loan demand and deposit withdrawal requirements and to service normal operating expenses. The Corporation sets liquidity management guidelines for both the consolidated balance sheet, as well as for the Corporation, specifically to ensure that the Corporation is a source of strength for its regulated, deposit-taking banking subsidiary.

The Corporation's primary source of funding is proceeds from customer deposits, other borrowings, loan repayments, and securities available for sale. Cash flows from operations are a significant component of liquidity risk management and include both deposit maturities and scheduled cash flows from loan and investment maturities payments. Cash flows from operating activities decreased in the first half of 2004 mainly due to greater funding needs for originations of mortgage loans held for sale than proceeds received from the sale of such loans, partially offset by net income, a decrease in other assets and an increase in other liabilities. Cash flows used in investing activities declined in the first half of 2004 as the purchases of securities available for sale and loan originations exceeded the sale and maturities of securities available for sale. Cash flows from financing activities increased mainly due to an increase in deposits to fund the increase in securities available for sale and loans, partially offset by a decrease in borrowings and dividends paid.

If additional funding sources are needed, the Bank has access to federal fund lines at correspondent banks and borrowings from the Federal Reserve discount window. In addition to these sources, as described above, the Bank is a member of the FHLB, which provides access to FHLB lending sources. At June 30, 2004, the Bank had an available

line of credit with the FHLB totaling \$1.16 billion with \$1.12 billion outstanding. At June 30, 2004, the Bank also had federal funds back-up lines of credit totaling \$70.0 million, of which there were no amounts outstanding. At June 30, 2004, the Corporation had lines of credit with SunTrust Bank totaling \$25.0 million with \$15.0 million outstanding and commercial paper outstandings of \$41.6 million.

Another source of liquidity is the securities available for sale portfolio. See **Securities Available for Sale** for further discussion. Management believes the Bank's sources of liquidity are adequate to meet loan demand, operating needs and deposit withdrawal requirements.

### **Capital Management**

The objective of effective capital management is to generate above market returns on equity to our 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 June 30, 2004 decreased to \$283.8 million, representing 6.54 percent of period-end assets compared to \$299.4 million or 7.12 percent of period-end assets at December 31, 2003. The after-tax unrealized loss on securities available for sale at June 30, 2004 was \$18.8 million compared to an after-tax



unrealized gain of \$6.2 million at December 31, 2003. This decrease was due to an increase in interest rates across the yield curve. In addition, cash dividends of \$0.185 per share resulted in cash dividend payments of \$11.0 million for the six months ended June 30, 2004. These decreases were partially offset by net income of \$19.5 million.

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 June 30, 2004, 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 and six months ended June 30, 2004.

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 June 30, 2004, no shares had been repurchased under this authorization.

At June 30, 2004, the Corporation and the Bank were in compliance with all existing capital requirements. The most recent notifications from the Corporation's and the Bank's various regulators categorized the Corporation and the Bank as well capitalized under the regulatory framework for prompt corrective action. In the judgment of management, there have been no events or conditions since those notifications 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 Fourteen**  
**Capital Ratios**

(Dollars in thousands)	Risk-Based Capital					
	Leverage Capital (1)		Tier 1 Capital (2)		Total Capital (2)	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Actual	\$281,980	6.56%	\$281,980	9.92%	\$308,335	10.85%
Required	171,825	4.00	113,694	4.00	227,389	8.00
Excess	110,155	2.56	168,286	5.92	80,946	2.85

(1) Percentage of total adjusted average assets. The Federal Reserve Board minimum leverage ratio requirement is 3.00 percent to 5.00 percent, depending on the institution's composite rating as determined by its regulators. The Federal Reserve Board has not advised the Corporation of any specific requirement applicable to it.

(2) Percentage of risk-weighted assets.

#### **Regulatory Recommendations**

During the third quarter of 2003, the Bank entered into a written agreement (the Written Agreement) with the Federal Reserve Bank of Richmond (the Federal Reserve Bank) and the Office of the North Carolina Commissioner of Banks (the Banking Commissioner), the Bank's primary federal and state regulatory agencies. The Written Agreement arose out of certain previously disclosed regulatory examinations and required the Bank to take appropriate actions to improve its programs and procedures for complying with the Currency and Foreign Transactions Reporting Act and the anti-money laundering provisions of Regulation H of the Board of Governors of the Federal Reserve System. The Bank subsequently took substantial actions, and adopted and implemented a number of policies and procedures, to address the concerns of the regulatory agencies. As a result of these actions, the Federal Reserve Bank, in concurrence with the Banking Commissioner, terminated the Written Agreement effective July 2, 2004.

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 January 2003, the FASB issued Financial Accounting Standards Board Interpretation No. 46, ( FIN 46 ), Consolidation of Variable Interest Entities, which addresses consolidation of variable interest entities by business enterprises. Variable interest entities are entities with equity interests that do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of expected losses if they occur, receive a majority of the entity's residual returns if they occur, or both. The enterprise that consolidates the variable interest entity is called the primary beneficiary of that entity. Under FIN 46 an enterprise that holds significant variable interests in a variable interest entity but is not the primary beneficiary is required to disclose the nature, purpose, size, and activities of the variable interest entity, its exposure to loss as a result of the variable interest holder's involvement with the entity, and the nature of its involvement with the entity and date when the involvement began. The primary beneficiary of a variable interest entity is required to disclose the nature, purpose, size, and activities of the variable interest entity, the carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations, and any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary. In December 2003, the FASB issued a revision to FIN 46 ( FIN 46 R ), which clarifies and interprets certain provisions of FIN 46, without changing the basic accounting model of FIN 46. The Corporation adopted the provisions of FIN 46 and FIN 46 R effective March 2004 with no material effect on its consolidated financial statements. At June 30, 2004, the Corporation did not have any significant investments in variable interest entities.

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 does not expect adoption of SOP 03-03 to have a material effect on its consolidated financial statements.

In March 2004, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 105 ( SAB 105 ), which contains specific guidance on the inputs to a valuation-recognition model to measure loan commitments accounted for at fair value. SAB 105 requires that fair-value measurement include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected future cash flows related to the customer relationship or loan servicing. SAB 105 is effective for mortgage-loan commitments that are accounted for as derivatives and are entered into after June 30, 2004. The Corporation adopted SAB 105 on June 30, 2004, with no 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 38 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.

## **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. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

#### **(c) Recent sales of Unregistered Securities**

On July 7, 2003, the Corporation, through First Charter Bank, its primary banking subsidiary, acquired all of the outstanding shares of a third party benefits administrator pursuant to a Merger Agreement dated as of the same date (the Merger Agreement). No underwriters were used in connection with this transaction. In connection with this transaction, the Corporation issued an aggregate of 78,441 shares of the Corporation's common stock to John Googe and Jeannie Felts, the shareholders of such acquired entity. The issuance of the shares in connection with this transaction was exempt from the registration requirements of the Securities Act of 1933, as amended, in accordance with Section 4(2) thereof, as a transaction by an issuer not involving a public offering. The Merger Agreement also contemplates additional, subsequent issuances of the Corporation's common stock based upon the future performance of the acquired entity. The Corporation expects the value of these issuances, if earned, to total approximately \$880,000. There were no additional issuances of the Corporation's common stock during the six months ended

June 30, 2004.

**(e) Issuer Purchases of Equity Securities**

The following table summarizes the Corporation's repurchases of its common stock during the quarter ended June 30, 2004.

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
April 1, 2004-April 30, 2004				1,625,400
May 1, 2004-May 31, 2004				1,625,400
June 1, 2004-June 30, 2004	—	—	—	1,625,400
<b>Total</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>1,625,400</b>

(1) On January 24, 2002, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to 1,500,000 shares of the Corporation's common stock from time to time. As of June 30, 2004, the Corporation had repurchased 1,374,600 shares under this authorization. No shares were repurchased under this authorization during the quarter ended June 30, 2004. On November 3, 2003, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to an additional 1,500,000 shares of the Corporation's common stock from time to time. As of June 30, 2004, 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**

(a) First Charter Corporation's Annual Meeting of Shareholders was held on April 28, 2004.

(c) The following are the voting results on each matter (exclusive of procedural matters) submitted to the shareholders:

1. To elect six directors to the Corporation's Board of Directors with terms expiring in 2007 and one director with a term expiring in 2006.

	<b>For</b>	<b>Withheld</b>
Harold D. Alexander	22,047,283	546,908
H. Clark Goodwin	21,857,099	737,092
Lawrence M. Kimbrough	21,704,190	890,001
Samuel C. King, Jr.	22,048,639	545,552
Jerry E. McGee	22,064,866	529,325
Thomas R. Revels	21,949,266	644,925
Ellen L. Messinger	21,871,347	722,844

2. To ratify the action of the Corporation's Audit Committee in appointing KPMG LLP as the Corporation's independent certified public accountants for 2004.

For	21,758,992
Against	595,245
Abstain	239,954

## Item 5. Other Information

### (a) Amendment to Procedures by which Shareholders may Recommend Director Nominees

During the second quarter of 2004, the Board of Directors of the Corporation (the Board) modified the advance notice requirements with respect to shareholder recommendations of nominees for election to the Board. At a meeting of the Board held on April 25, 2004, the Board approved amendments to the Corporation's Bylaws that, among other things, change the dates during which shareholder recommendations are required to be received by the Corporate Secretary in order to allow the Board's Governance and Nominating Committee sufficient time to evaluate those recommendations in advance of the annual meeting of shareholders or a special meeting of shareholders at which one or more directors are to be elected.

Prior to amendment, in order for a shareholder to properly bring a nomination before the annual meeting of shareholders in a given year, a shareholder was required to deliver written notice to the Corporate Secretary not later than the close of business on the 50th day, and not earlier than the close of business on the 75th day, prior to the first anniversary of the prior year's annual meeting of shareholders. In order for a shareholder to properly bring a nomination before a special meeting of shareholders at which one or more directors were to be elected, a shareholder was required to deliver written notice to the Corporate Secretary not earlier than the close of business on the 75th day prior to such special meeting and not later than the close of business on the later of the 50th day prior to such special meeting or the 10th day following the day on which public announcement of the date of the special meeting and of the nominees proposed by the Board to be elected at such meeting was first made by the Corporation. As amended, for an annual meeting, a shareholder must now deliver the written notice to the Corporate Secretary not later than the close of business on the 90th day, and not earlier than the close of business on the 120th day, prior to the first anniversary of the prior year's annual meeting of shareholders. For a special meeting, a shareholder must now deliver the written notice to the Corporate Secretary not earlier than the close of business on the 120th day prior to such special meeting and not later than the close of business on the later of the 90th day prior to such special meeting or the 10th day following the day on which public announcement of the date of the special meeting and of the nominees proposed by the Board to be elected at such meeting is first made by the Corporation. The dates by which a shareholder must bring this written notice in the event that the annual meeting of shareholders is more than 30 days before, or more than 60 days after, the first anniversary of the prior annual meeting of shareholders have been similarly modified.

The full text of the amended advance notice requirements is as follows:

### "Section 15. Nomination of Directors and Shareholder Business

#### (a) Annual Meetings of Shareholders.

- (1) Nominations of persons for election to the Board of Directors of the Corporation may be made at an annual meeting of shareholders (i) pursuant to the Corporation's notice of meeting, (ii) by or at the direction of the Board of Directors or (iii) by any shareholder of the Corporation who was a shareholder of record at the time of giving of notice provided for in this Section 15, who is entitled to vote at the meeting and who complies with the notice procedures set forth herein.
- (2) For nominations to be properly brought before an annual meeting by a shareholder pursuant to clause (iii) of paragraph (a)(1) of this Section 15, the shareholder must have given timely notice thereof in writing to the Secretary of the Corporation. To be timely, a shareholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the 90th day nor earlier than the close of business on the 120th day prior to the first anniversary of the preceding year's annual meeting; provided, however, that in the event that the date of the annual



meeting is more than 30 days before or more than 60 days after such anniversary date, notice by the shareholder to be timely must be so delivered not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of the 90th day prior to such annual meeting or the 10th day following the day on which public announcement of the date of such meeting is first made by the Corporation. In no event shall the public announcement of an adjournment of an annual meeting commence a

new time period for the giving of a shareholder's notice as described above. Such shareholder's notice shall set forth (i) as to each person whom the shareholder proposes to nominate for election or re-election as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (the Exchange Act) (including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected); and (ii) as to the shareholder giving the notice and the beneficial owner, if any, on whose behalf the nomination is made (x) the name and address of such shareholder, as they appear on the Corporation's books, and of such beneficial owner and (y) the class and number of shares of the Corporation that are owned beneficially and of record by such shareholder and such beneficial owner.

(b) Special Meetings of Shareholders.

Only such business shall be conducted at a special meeting of shareholders as shall have been brought before the meeting pursuant to the Corporation's notice of meeting. Nominations of persons for election to the Board of Directors may be made at a special meeting of shareholders at which directors are to be elected pursuant to the Corporation's notice of meeting (i) by or at the direction of the Board of Directors or (ii) provided that the Board of Directors has determined that directors shall be elected at such meeting, by any shareholder of the Corporation who is a shareholder of record at the time of giving of notice provided for in this Section 15, who shall be entitled to vote at the meeting and who complies with the notice procedures set forth herein. In the event the Corporation calls a special meeting of shareholders for the purpose of electing one or more directors to the Board of Directors, any such shareholder may nominate a person or persons for election to such positions as specified in the Corporation's notice of meeting, if the shareholder's notice required by paragraph (a)(2) hereof shall be delivered to the Secretary at the principal executive offices of the Corporation not earlier than the close of business on the 120th day prior to such special meeting and not later than the close of business on the later of the 90th day prior to such special meeting or the 10th day following the day on which public announcement of the date of the special meeting and of the nominees proposed by the Board of Directors to be elected at such meeting is first made by the Corporation. In no event shall the public announcement of an adjournment of a special meeting commence a new time period for the giving of a shareholders' notice as described herein.

(b) Amendment to Procedure for Submission of Shareholder Proposals

In addition to changing to the dates during which shareholder recommendations for director nominees are required to be delivered to the Corporate Secretary, the amended Bylaws also provide an advance notice provision for all other general proposals submitted by shareholders in connection with an annual meeting of shareholders. The deadline for submission of shareholder proposals pursuant to Rule 14a-8 under the Exchange Act for inclusion in the Corporation's proxy statement for the 2005 Annual Meeting of Shareholders remains November 17, 2004. As amended, shareholder proposals not to be included in the proxy statement must now be delivered to the Corporate Secretary at the principal executive offices of the Corporation not later than the close of business on the 90th day, and not earlier than the close of business on the 120th day, prior to the first anniversary of the preceding year's annual meeting of shareholders to be considered timely pursuant to Rule 14a-4 and 14a-5(e) under the Exchange Act. As a result of this change, the date by which such notice must be delivered to the Corporation for the 2005 Annual Meeting of Shareholders has been changed from January 31, 2005, as published in the Corporation's 2004 proxy statement, to January 28, 2005. Such proposal also may not be submitted earlier than December 29, 2004.

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

<b>Exhibit No. (per Exhibit Table in item 601 of Regulation S-K)</b>	<b>Description of Exhibits</b>
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
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

(b) The following report on Form 8-K was filed by the registrant during the quarter ended June 30, 2004:

Current Report on Form 8-K dated April 7, 2004 and filed April 7, 2004, Item 5.

The following report on Form 8-K was furnished by the registrant during the quarter ended June 30, 2004:

Current Report on Form 8-K dated April 13, 2004 and filed April 13, 2004, Items 9 and 12.

**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: August 5, 2004

By: /s/ Robert O. Bratton

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Robert O. Bratton  
Executive Vice President &  
Chief Financial Officer