

COLONIAL BANGROUP INC

Form 10-Q

August 05, 2008

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2008**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM            TO            .**  
**COMMISSION FILE NUMBER: 1-13508**

**THE COLONIAL BANGROUP, INC.**

(Exact name of registrant as specified in its charter)

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**63-0661573**  
(I.R.S. Employer  
Identification No.)

**100 Colonial Bank Blvd.**

**Montgomery, AL**  
(Address of principal executive offices)

**36117**  
(Zip Code)

**(334) 676-5000**

(Registrant's telephone number, including area code)

**None**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to the filing requirements for at least the past 90 days. YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

Class	Outstanding at July 31, 2008
Common Stock, \$2.50 Par Value	202,120,807

**Table of Contents**

**THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES**

**INDEX**

	<b>Page Number</b>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. <u>Financial Statements (Unaudited)</u>	4
<u>Consolidated Statements of Condition June 30, 2008 and December 31, 2007</u>	4
<u>Consolidated Statements of Income Three months ended June 30, 2008 and June 30, 2007, and six months ended June 30, 2008 and June 30, 2007</u>	5
<u>Consolidated Statements of Comprehensive Income Three months ended June 30, 2008 and June 30, 2007, and six months ended June 30, 2008 and June 30, 2007</u>	6
<u>Consolidated Statement of Changes in Shareholders' Equity Six months ended June 30, 2008</u>	7
<u>Consolidated Statements of Cash Flows Six months ended June 30, 2008 and June 30, 2007</u>	8
<u>Notes to the Unaudited Consolidated Financial Statements June 30, 2008</u>	9
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	56
Item 4. <u>Controls and Procedures</u>	56
<b>PART II. OTHER INFORMATION</b>	
Item 1. <u>Legal Proceedings</u>	57
Item 1A. <u>Risk Factors</u>	57
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	58
Item 3. <u>Defaults Upon Senior Securities</u>	58
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	59
Item 5. <u>Other Information</u>	60
Item 6. <u>Exhibits</u>	60
<u>SIGNATURE</u>	61

**Table of Contents**

**THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES**

**CAUTIONARY STATEMENT PURSUANT TO SAFE HARBOR PROVISIONS**

**OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:**

**FORWARD-LOOKING STATEMENTS**

*This report and the information incorporated by reference contain forward-looking statements within the meaning of the federal securities laws. Words such as believes, estimates, plans, expects, should, may, might, outlook, potential and anticipates, the negative of these terms and similar expressions as they relate to BancGroup (including its subsidiaries and its management), are intended to identify forward-looking statements. The forward-looking statements in this report are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in or implied by the statements.*

*In addition to factors mentioned elsewhere in this report or previously disclosed in BancGroup's Securities and Exchange Commission (the SEC) reports (accessible on the SEC's website at [www.sec.gov](http://www.sec.gov) or on BancGroup's website at [www.colonialbank.com](http://www.colonialbank.com)), the following factors, among others, could cause actual results to differ materially from forward-looking statements, and future results could differ materially from historical performance. These factors are not exclusive:*

*losses in our loan portfolio are greater than estimated or expected;*

*an inability to raise additional capital on terms and conditions that are satisfactory;*

*the impact of current economic conditions on our ability to borrow additional funds to meet our liquidity needs;*

*economic conditions affecting real estate values and transactions in BancGroup's market and/or general economic conditions, either nationally or regionally, that are less favorable or take longer to recover than expected;*

*changes in the interest rate environment which expand or reduce margins or adversely affect critical estimates as applied and projected returns on investments and fair values of assets;*

*deposit attrition, customer loss or revenue loss in the ordinary course of business;*

*increases in competitive pressure in the banking industry and from non-banks;*

*costs or difficulties related to the integration of the businesses of BancGroup and institutions it acquires are greater than expected;*

*the inability of BancGroup to realize elements of its strategic plans for 2008 and beyond;*

*natural disasters in BancGroup's primary market areas result in prolonged business disruption or materially impair the value of collateral securing loans;*

*management's assumptions and estimates underlying critical accounting policies prove to be inadequate or materially incorrect or are not borne out by subsequent events;*

*the impact of recent and future federal and state regulatory changes;*

*current or future litigation, regulatory investigations, proceedings or inquiries;*

*strategies to manage interest rate risk may yield results other than those anticipated;*

*changes which may occur in the regulatory environment;*

*a significant rate of inflation (deflation);*

*unanticipated litigation or claims;*

*acts of terrorism or war; and*

*changes in the securities markets.*

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

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CONDITION****(Unaudited)**

	June 30, 2008	December 31, 2007
	(In thousands, except share amounts)	
<b>ASSETS</b>		
Cash and due from banks	\$ 451,281	\$ 474,948
Interest bearing deposits in banks	101,391	28,993
Federal funds sold	8,891	71,167
Securities purchased under agreements to resell	2,185,174	2,049,664
Securities available for sale	3,452,686	3,681,282
Held to maturity securities (fair value: 2008, \$1,303; 2007, \$1,361)	1,173	1,228
Loans held for sale	1,984,723	1,544,222
Total loans, net of unearned income:	15,468,832	15,923,178
Less: Allowance for loan losses	(247,009)	(238,845)
Loans, net	15,221,823	15,684,333
Premises and equipment, net	498,941	500,558
Goodwill	1,008,298	1,008,168
Other intangible assets, net	57,917	63,437
Other real estate owned	113,470	15,760
Bank-owned life insurance	485,840	475,593
Accrued interest and other assets	459,683	376,636
Total	\$ 26,031,291	\$ 25,975,989
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Noninterest bearing transaction accounts	\$ 2,912,071	\$ 2,988,457
Interest bearing transaction accounts	6,052,774	6,783,116
Total transaction accounts	8,964,845	9,771,573
Time deposits	8,038,923	7,317,108
Brokered time deposits	1,345,397	1,455,586
Total deposits	18,349,165	18,544,267
Repurchase agreements	525,724	568,721
Federal funds purchased	135,000	
Subordinated debt	612,134	386,434
Junior subordinated debt	108,248	108,256
Other long-term debt	3,317,359	3,529,146
Accrued expenses and other liabilities	268,611	272,536
Total liabilities	23,316,241	23,409,360
Minority interest/REIT preferred securities	293,058	293,058
Contingencies and commitments (Note 8)		
Preferred stock, \$2.50 par value; 50,000,000 shares authorized and none issued at both June 30, 2008 and December 31, 2007		

## Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

Preference stock, \$2.50 par value; 1,000,000 shares authorized and none issued at both June 30, 2008 and December 31, 2007		
Common stock, \$2.50 par value; 400,000,000 shares authorized; 211,829,234 and 167,407,169 shares issued and 201,862,507 and 157,440,442 shares outstanding at June 30, 2008 and December 31, 2007, respectively	<b>529,574</b>	418,518
Additional paid in capital	<b>1,231,797</b>	1,004,888
Retained earnings	<b>1,060,857</b>	1,094,916
Treasury stock, at cost (9,966,727 shares at both June 30, 2008 and December 31, 2007)	<b>(240,336)</b>	(240,336)
Accumulated other comprehensive loss, net of taxes	<b>(159,900)</b>	(4,415)
<b>Total shareholders equity</b>	<b>2,421,992</b>	2,273,571
 Total	 <b>\$ 26,031,291</b>	 \$ 25,975,989

See Notes to the Unaudited Consolidated Financial Statements

**Table of Contents****THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

	Three Months Ended		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
<b>(In thousands, except per share amounts)</b>				
<b>Interest Income:</b>				
Interest and fees on loans	\$ 270,637	\$ 325,180	\$ 572,277	\$ 640,488
Interest and dividends on securities	51,957	35,264	104,603	77,699
Interest on federal funds sold and other short-term investments	25,146	23,430	54,397	42,566
<b>Total interest income</b>	<b>347,740</b>	<b>383,874</b>	<b>731,277</b>	<b>760,753</b>
<b>Interest Expense:</b>				
Interest on deposits	120,407	139,069	257,913	272,153
Interest on short-term borrowings	5,078	13,730	20,375	37,562
Interest on long-term debt	47,831	40,858	96,941	80,876
<b>Total interest expense</b>	<b>173,316</b>	<b>193,657</b>	<b>375,229</b>	<b>390,591</b>
<b>Net Interest Income</b>	<b>174,424</b>	<b>190,217</b>	<b>356,048</b>	<b>370,162</b>
Provision for loan losses	79,000	6,105	114,543	8,355
<b>Net Interest Income After Provision for Loan Losses</b>	<b>95,424</b>	<b>184,112</b>	<b>241,505</b>	<b>361,807</b>
<b>Noninterest Income:</b>				
Service charges on deposit accounts	19,259	18,694	38,487	36,373
Electronic banking	5,275	4,648	10,279	9,049
Other retail banking fees	2,540	3,255	5,088	6,867
<b>Retail banking fees</b>	<b>27,074</b>	<b>26,597</b>	<b>53,854</b>	<b>52,289</b>
Mortgage banking origination and sales	7,953	3,660	14,713	6,847
Financial planning services	5,061	4,283	9,873	8,105
Mortgage warehouse fees	1,251	6,332	2,246	13,287
Bank-owned life insurance	5,169	5,002	10,289	9,957
Securities gains, net	3,025	1,116	9,100	2,097
Securities restructuring losses				(36,006)
Gain on sale of mortgage loans				3,850
Gain on sale of merchant services		4,900		4,900
Other income	6,190	6,891	13,395	8,674
<b>Total noninterest income</b>	<b>55,723</b>	<b>58,781</b>	<b>113,470</b>	<b>74,000</b>
<b>Noninterest Expense:</b>				
Salaries and employee benefits	74,761	70,256	148,428	139,810
Occupancy expense of bank premises, net	24,064	18,722	47,119	37,227
Furniture and equipment expenses	15,134	13,350	29,837	26,472
Professional services	7,807	4,628	13,445	8,728
FDIC insurance and other regulatory fees	4,414	1,232	8,976	2,445
Amortization of intangible assets	4,142	3,201	8,305	6,252
Electronic banking and other retail banking expenses	4,136	5,507	8,293	9,719
Loan and real estate related costs	4,486	898	7,135	1,236



Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

Communications	2,863	2,900	5,682	5,891
Advertising	2,384	3,683	4,987	5,898
Postage and courier	2,270	2,692	4,892	5,331
Loss on equity investments	1,720	670	4,467	925
Travel	1,522	1,950	2,961	3,689
Severance expense	550	520	786	3,545
Merger related expenses		1,116		1,545
Net losses related to the early extinguishment of debt	4,111	2,512	10,043	6,908
Other expense	9,803	7,647	22,789	14,004
<b>Total noninterest expense</b>	<b>164,167</b>	<b>141,484</b>	<b>328,145</b>	<b>279,625</b>
Minority interest expense/REIT preferred dividends	5,336	2,312	10,672	2,312
(Loss) income before income taxes	(18,356)	99,097	16,158	153,870
Applicable income tax (benefit) expense	(9,400)	32,978	317	51,272
<b>Net (Loss) Income</b>	<b>\$ (8,956)</b>	<b>\$ 66,119</b>	<b>\$ 15,841</b>	<b>\$ 102,598</b>
<b>(Loss) Earnings per share:</b>				
Basic	\$ (0.05)	\$ 0.43	\$ 0.09	\$ 0.67
Diluted	\$ (0.05)	\$ 0.43	\$ 0.09	\$ 0.66
<b>Average number of shares outstanding:</b>				
Basic	188,730	154,217	172,844	153,268
Diluted	188,730	155,176	173,072	154,336
<b>Dividends declared per share</b>	<b>\$ 0.095</b>	<b>\$ 0.1875</b>	<b>\$ 0.285</b>	<b>\$ 0.375</b>

See Notes to the Unaudited Consolidated Financial Statements

**Table of Contents**

**THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
<b>Net (loss) income</b>	<b>\$ (8,956)</b>	\$ 66,119	<b>\$ 15,841</b>	\$ 102,598
<b>Other comprehensive (loss) income, net of taxes:</b>				
<b>Available for sale securities:</b>				
Unrealized losses on securities available for sale arising during the period, net of income taxes of \$18,246 and \$82,813 in 2008 and \$18,242 and \$12,966 in 2007, respectively	(59,016)	(33,877)	(155,016)	(24,080)
Less: reclassification adjustment for net (gains) losses on securities available for sale included in net income, net of income taxes of \$0 and \$2,437 in 2008 and \$391 and \$(11,868) in 2007, respectively		(725)	(3,638)	22,041
<b>Cash flow hedging instruments:</b>				
Reclassification adjustment for losses included in net income, net of income taxes of \$(853) and \$(1,707) in 2008 and \$(853) and \$(1,707) in 2007, respectively	1,585	1,585	3,169	3,169
<b>Comprehensive (loss) income</b>	<b>\$ (66,387)</b>	\$ 33,102	<b>\$ (139,644)</b>	\$ 103,728

See Notes to the Unaudited Consolidated Financial Statements

Table of Contents

**THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**

(Unaudited)

	Common Stock		Additional Paid In Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
	Shares	Amount					
Balance, December 31, 2007	157,440,442	\$ 418,518	\$ 1,004,888	\$ (240,336)	\$ 1,094,916	\$ (4,415)	\$ 2,273,571
Adoption of EITF 06-4 and 06-10					(671)		(671)
Shares issued under:							
Directors plan	28,712	72	445				517
Stock option plans	50,700	127	489				616
Restricted stock plan, net	601,428	1,504	(1,504)				
Employee stock purchase plan	26,330	66	204				270
Dividend reinvestment plan	14,449	36	114				150
Common stock offering	43,700,446	109,251	224,645				333,896
Tax benefit (shortfall) from stock based compensation			(37)				(37)
Stock-based compensation expense			2,553				2,553
Net income					15,841		15,841
Cash dividends (\$0.285 per share)					(49,229)		(49,229)
Change in unrealized loss on securities available for sale, net of taxes and reclassification adjustments						(158,654)	(158,654)
Reclassification of cash flow hedging losses, net of taxes						3,169	3,169
<b>Balance, June 30, 2008</b>	<b>201,862,507</b>	<b>\$ 529,574</b>	<b>\$ 1,231,797</b>	<b>\$ (240,336)</b>	<b>\$ 1,060,857</b>	<b>\$ (159,900)</b>	<b>\$ 2,421,992</b>

See Notes to the Unaudited Consolidated Financial Statements

**Table of Contents****THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	Six Months Ended June 30,	
	2008	2007
	(In thousands)	
<b>Cash flows from operating activities:</b>		
Net income	\$ 15,841	\$ 102,598
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation, amortization and accretion	33,908	19,359
Provision for loan losses	114,543	8,355
Deferred taxes	(4,203)	650
Securities gains, net	(9,100)	(2,097)
Securities restructuring losses		36,006
Gain on sale of mortgage loans		(3,850)
Gain on sale of other assets	(6,725)	(858)
Net increase in loans held for sale	(434,880)	(566,352)
Decrease (increase) in interest and other receivables	24,119	(21,175)
Decrease (increase) in prepaids	8,547	(5,828)
(Increase) decrease in other assets	(16,421)	13,260
(Decrease) increase in other liabilities	(5,601)	26,009
Increase (decrease) in accrued income taxes	1,648	(13,458)
(Decrease) increase in interest payable	(7,523)	2,360
Excess tax benefit from stock based compensation	(17)	(762)
Other, net	(3,018)	(3,904)
Total adjustments	(304,723)	(512,285)
Net cash from operating activities	(288,882)	(409,687)
<b>Cash flows from investing activities:</b>		
Proceeds from maturities and calls of securities available for sale	57,216	69,505
Proceeds from sales of securities available for sale	293,959	1,642,704
Purchases of securities available for sale	(356,228)	(1,041,123)
Proceeds from maturities of held to maturity securities	55	454
Net increase in securities purchased under agreements to resell	(132,485)	(580,586)
Net decrease in loans excluding proceeds from sale of loans	199,773	112,940
Proceeds from sales of loans	34,830	493,101
Net cash paid in bank acquisition		(77,309)
Capital expenditures	(43,458)	(60,917)
Proceeds from bank owned life insurance	114	319
Proceeds from sale of other assets	38,541	10,023
Net (contributions to) return of investment in affiliates	(8,672)	3,551
Net cash from investing activities	83,645	572,662
<b>Cash flows from financing activities:</b>		
Net (decrease) increase in demand, savings and time deposits	(195,447)	168,191
Net increase (decrease) in federal funds purchased, repurchase agreements and other short-term borrowings	92,003	(967,700)
Proceeds from issuance of long-term debt, net	242,059	600,000

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

Repayment of long-term debt	<b>(232,632)</b>	(205,477)
Purchase of common stock		(57,135)
Proceeds from issuance of common stock	<b>334,921</b>	5,483
Proceeds from issuance of REIT preferred securities		293,278
Excess tax benefit from stock-based compensation	<b>17</b>	762
Dividends paid	<b>(49,229)</b>	(57,365)
Net cash from financing activities	<b>191,692</b>	(219,963)
Net decrease in cash and cash equivalents	<b>(13,545)</b>	(56,988)
Cash and cash equivalents at the beginning of the year	<b>575,108</b>	442,682
Cash and cash equivalents at June 30	<b>\$ 561,563</b>	\$ 385,694

See Notes to the Unaudited Consolidated Financial Statements

---

**Table of Contents**

**THE COLONIAL BANCGROUP, INC. AND SUBSIDIARIES**

**NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1: Accounting Policies and Basis of Presentation**

The accounting and reporting policies of The Colonial BancGroup, Inc. and its subsidiaries (referred to herein as BancGroup, Colonial, or the Company) are detailed in the Company's 2007 Annual Report on Form 10-K. As discussed more fully below, effective January 1, 2008 Colonial changed certain of those policies as a result of the adoption of new accounting standards. These unaudited interim financial statements should be read in conjunction with the audited financial statements and footnotes included in BancGroup's 2007 Annual Report on Form 10-K.

In the opinion of BancGroup's management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly BancGroup's financial position as of June 30, 2008 and December 31, 2007 and the results of operations and cash flows for the interim periods ended June 30, 2008 and 2007. All 2008 interim amounts have not been audited, and the results of operations for the interim periods herein are not necessarily indicative of the results of operations to be expected for the year.

During the first quarter of 2008, inadvertent errors relating to prior year financial statements, principally relating to the accounting for derivatives and the carrying value of loans held for sale, were identified. The effect of these errors, individually and in the aggregate, was not material to any previously issued financial statements and is not expected to be material to the Company's expected results of operations, financial position or cash flows for fiscal 2008. As a result, no adjustments to prior period amounts have been made. Adjustments that reduced net income by \$4.0 million (\$6.6 million pretax) were recorded in the first quarter of 2008, representing the cumulative effect of these errors on prior periods.

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

***Fair Value Measurements***

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about assets and liabilities measured at fair value. The definition of fair value in SFAS 157 retains the notion of exchange price; however, it focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), rather than the price that would be paid to acquire the asset or received to assume the liability (an entry price). Under the Statement, a fair value measure should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of nonperformance. To increase consistency and comparability in fair value measures, SFAS 157 establishes a three-level fair value hierarchy to prioritize the inputs used in valuation techniques between observable inputs that reflect quoted prices in active markets (Level 1), inputs other than quoted prices that are directly or indirectly observable for the asset or liability (Level 2) and unobservable data (Level 3). The Statement does not expand the use of fair value accounting in any new circumstances.

On February 12, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) SFAS 157-2, *Effective Date of FASB Statement No. 157*. This FSP permits delayed application of the provisions of SFAS 157 to nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis to fiscal years beginning after November 15, 2008.

The Company has elected to delay application of the provisions of SFAS 157 to nonfinancial assets and liabilities under FSP SFAS 157-2. The major categories of assets and liabilities that are recognized or disclosed at fair value for which the provisions of SFAS 157 have not been applied include reporting units measured at fair

---

**Table of Contents**

value in the first step of a goodwill impairment test under SFAS 142, *Goodwill And Other Intangible Assets*, and nonfinancial long-lived assets measured at fair value for an impairment assessment under SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

The Company's adoption of SFAS 157 did not have an impact on BancGroup's financial statements.

See Note 4, *Fair Value Measurements*, for disclosures related to fair value measurements.

***Loans Held for Sale***

Loans held for sale include originated loans and acquired short-term participations in mortgage loans. Prior to January 1, 2008, loans held for sale were carried at the lower of aggregate cost or market. As a result of adopting SFAS 157 on January 1, 2008, loans held for sale are now carried at the lower of aggregate cost or fair value. This change did not have a material impact on the Company's financial statements.

***Other Accounting Standards***

The following is a list of other accounting standards which became effective as of January 1, 2008 but did not have a material impact on BancGroup and did not change the accounting and reporting policies detailed in the Company's 2007 Annual Report on Form 10-K:

SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* SFAS 159 permits companies to elect to measure certain eligible items at fair value. Subsequent unrealized gains and losses on those items will be reported in earnings. Upfront costs and fees related to those items will be reported in earnings as incurred and not deferred. As the Company did not elect to apply SFAS 159 to any of its existing eligible items as of January 1, 2008, the adoption of SFAS 159 did not have an impact on BancGroup's financial statements. The Company may elect to apply SFAS 159 to certain newly recognized eligible items in the future.

FSP FIN 39-1, *Amendment of FASB Interpretation No. 39* FSP FIN 39-1 amends Interpretation No. 39 to permit a reporting entity to offset the right to reclaim cash collateral (a receivable), or the obligation to return cash collateral (a payable), against derivative instruments executed with the same counterparty under the same master netting arrangement. The adoption of FSP FIN 39-1 did not have a material impact on BancGroup's financial statements.

Emerging Issues Task Force (EITF) 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* EITF 06-4 stipulates that an agreement by the employer to share a portion of the proceeds of a life insurance policy with the employee during the postretirement period is a postretirement benefit arrangement for which a liability must be recorded. As a result of adopting EITF 06-4 on January 1, 2008, BancGroup recognized an increase of \$539,000 to the balance of other liabilities and a corresponding decrease to beginning retained earnings.

EITF 06-10, *Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements* EITF 06-10 stipulates that a liability should be recognized for a postretirement benefit obligation associated with a collateral assignment arrangement if, on the basis of the substantive agreement with the employee, the employer has agreed to maintain a life insurance policy during the postretirement period or provide a death benefit. The employer also must recognize and measure the associated asset on the basis of the terms of the collateral assignment arrangement. As a result of adopting EITF 06-10 on January 1, 2008, BancGroup recognized an increase of \$257,000 to the balance of other liabilities, an increase of \$125,000 to the balance of other assets and a decrease of \$132,000 to beginning retained earnings.

Statement 133 Implementation Issue E23, *Hedging - General: Issues Involving the Application of the Shortcut Method under Paragraph 68* Issue E23 amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, to explicitly permit use of the shortcut method for hedging

**Table of Contents**

relationships in which: the interest rate swaps have a nonzero fair value at the inception of the hedging relationship, provided that this value is attributable solely to a bid-ask spread; the settlement date of the hedged item is after the swap trade date, provided that these dates differ because of generally established conventions in the marketplace in which the transaction is executed. The adoption of Issue E23 did not have an impact on BancGroup's financial statements.

SEC Staff Accounting Bulletin (SAB) 109, *Written Loan Commitments Recorded at Fair Value Through Earnings*. SAB 109 requires that the expected net future cash flows related to servicing of a loan be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The adoption of SAB 109 did not have a material impact on BancGroup's financial statements.

**Note 2: Recent Accounting Standards**

In December 2007, the FASB issued SFAS 141(R), *Business Combinations*, which is a revision of SFAS 141, *Business Combinations*. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination: recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and discloses information to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This Statement is effective for fiscal years beginning after December 15, 2008, and is to be applied prospectively. The Company is currently assessing the potential impact SFAS 141(R) will have on the financial statements.

In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*. SFAS 160 amends Accounting Research Bulletin 51, *Consolidated Financial Statements*, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be clearly reported as equity in the consolidated financial statements. Additionally, SFAS 160 requires that the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income. The provisions of this Statement are effective on a prospective basis for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, except for the presentation and disclosure requirements, which are required to be applied retrospectively. Early adoption is not permitted. The Company is currently assessing the potential impact SFAS 160 will have on the financial statements.

In March 2008, the FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, by requiring expanded disclosures about an entity's derivative instruments and hedging activities, but does not change SFAS 133's scope or accounting. This Statement requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. To meet those objectives, this Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures in a tabular format about fair value amounts of and gains and losses on derivative instruments including specific disclosures regarding the location and amounts of derivative instruments in the financial statements, and disclosures about credit risk related contingent features in derivative agreements. SFAS 161 also amends SFAS 107, *Disclosures about Fair Value of Financial Instruments*, to clarify that derivative instruments are subject to the SFAS 107 concentration of credit risk disclosures. The provisions of this Statement are effective for fiscal years beginning after November 15, 2008, and earlier application is permitted.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be



**Table of Contents**

included in the earnings allocation in calculating earnings per share under the two-class method described in SFAS 128, *Earnings per Share*. This FSP requires companies to treat unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) as a separate class of securities in calculating earnings per share. The provisions of this FSP are effective for fiscal years beginning after December 15, 2008; earlier application is not permitted. Upon adoption of this FSP, all prior-period earnings per share data presented must be adjusted retrospectively to conform to the provisions of this FSP. The Company is currently assessing the potential impact FSP EITF 03-6-1 will have on earnings per share.

In June 2008, the EITF reached a final consensus on Issue 08-3, *Accounting by Lessees for Maintenance Deposits*. EITF 08-3 stipulates that a maintenance deposit should be accounted for as a deposit asset when paid to the lessor if it is probable that the deposit will be refunded to the lessee. If it is determined that a maintenance deposit is less than probable of being refunded to the lessee, the deposit should be recognized as additional expense. If it is probable at inception of the lease that a portion of the deposit will not be refunded, the lessee should recognize as expense a pro-rata portion of the deposit as it is paid. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. This consensus is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. The effect of applying this consensus must be recognized as a cumulative effect of a change in accounting principle as of the beginning of the fiscal year in which the consensus is initially applied for all arrangements existing at the effective date. The Company is currently assessing the potential impact EITF 08-3 will have on the financial statements.

**Note 3: Supplemental Disclosure of Cash Flow Information**

	Six Months Ended June 30,	
	2008	2007
	(In thousands)	
Cash paid during the year for:		
Interest	\$ 378,801	\$ 381,814
Income taxes	23,896	48,000
Non-cash investing and financing activities:		
Transfer of loans to other real estate	\$ 115,362	\$ 11,090
Transfer of loans to loans held for sale	5,621	
Assets (non-cash) acquired in business combination		1,212,478
Liabilities assumed in business combination		980,302
Assets acquired under capital leases	2,115	2,136
Capital leases terminated		2,191

**Note 4: Fair Value Measurements**

BancGroup adopted the provisions of SFAS 157 on January 1, 2008. In February 2008, the FASB issued an FSP which permits delayed application of the provisions of SFAS 157 to nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis to fiscal years beginning after November 15, 2008. Since the Company has elected to delay application of the provisions of SFAS 157 to nonfinancial assets and liabilities in scope of this FSP, the information disclosed below does not consider the impact that SFAS 157 would have on such nonfinancial assets and liabilities. The major categories of assets and liabilities that are recognized or disclosed at fair value for which the provisions of SFAS 157 have not been applied include reporting units measured at fair value in the first step of a goodwill impairment test under SFAS 142 and nonfinancial long-lived assets measured at fair value for an impairment assessment under SFAS 144.

**Table of Contents**

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities.
- Level 2** Directly or indirectly observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates); or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities would include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

	Fair value measurements using:			
	Fair value at June 30, 2008	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
(In thousands)				
<b>Assets:</b>				
Securities available for sale(1)	\$ 3,277,112	\$ 1,719	\$ 3,275,393	\$
Derivative assets	234			234
Total	\$ 3,277,346	\$ 1,719	\$ 3,275,393	\$ 234
<b>Liabilities:</b>				
Derivative liabilities(2)	\$ 11,789	\$	\$ 1,606	\$ 10,183

(1) Securities available for sale as of June 30, 2008 per the Consolidated Statement of Condition include \$176 million in nonmarketable equity securities (Federal Home Loan Bank stock). As these securities are accounted for under the cost method, they are not included in the table above.

(2) FIN 39 permits the netting of derivative receivables and derivative payables when a legally enforceable master netting agreement exists between the Company and a derivative counterparty. A master netting agreement is an agreement between two counterparties who have multiple derivative contracts with each other that provide for the net settlement of all contracts, as well as cash collateral, through a single payment, in a single currency, in the event of default on or termination of any one contract. Derivative liabilities are presented net of cash collateral placed of \$7.1 million.

**Table of Contents**

The valuation techniques used to measure fair value for the items in the table above are as follows:

**Securities available for sale** The fair value of securities available for sale equals quoted market prices, if available. If quoted market prices are not available, fair value is determined using quoted market prices for similar securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange. Level 2 securities include mortgage-backed securities, other pass-through securities and collateralized mortgage obligations of government sponsored entities (GSE s) and private issuers and obligations of states and political subdivisions.

**Derivative assets and liabilities** For derivatives traded in over-the-counter markets where quoted market prices are not readily available, fair value is measured using models that primarily use market observable inputs, such as yield curves and option volatilities. For forward sales commitments on the retail portion of loans held for sale, fair value is based on changes in market prices of comparable securities traded in the market. Accordingly, these are classified as Level 2. In the first quarter of 2008, the Company's call options related to interests in short-term participations in mortgage loans, interest rate lock commitments and the related forward sales commitments were classified as Level 2. Because of the significance of unobservable inputs (such as the probability of funding) to the overall value of these instruments, they were transferred to Level 3 in the second quarter.

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized below:

	<b>Net derivative assets and (liabilities) (In thousands)</b>
Balance, April 1, 2008(1)	\$
Total net gains included in net income(2)	181
Net transfers into Level 3	(10,130)
Balance, June 30, 2008	\$ (9,949)
Net unrealized gains included in net income relating to assets and liabilities held at June 30, 2008(2)	\$ 181

(1) BancGroup did not have any Level 3 assets or liabilities as of either January 1, 2008 or March 31, 2008; therefore, the reconciliation of the beginning and ending balances of Level 3 assets and liabilities for the three and six months ended June 30, 2008 is the same.

(2) Approximately \$168,000 included in other noninterest income and \$13,000 in other noninterest expense.

Certain other assets are measured at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower of cost or fair value accounting or write-downs of individual assets due to impairment. For assets measured at fair value on a nonrecurring basis in the first six months of 2008 that were still held in the balance sheet at June 30, 2008, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets at quarter end.

	<b>Carrying value at June 30, 2008</b>		
	<b>Quoted prices in active markets for identical assets (Level 1)</b>	<b>Significant other observable inputs (Level 2)</b>	<b>Significant unobservable inputs (Level 3)</b>
<b>Total</b>	<b>(In thousands)</b>		

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

Loans held for sale	\$ 1,810,153	\$	\$ 1,810,153	\$
Loans	105,667			105,667

**Table of Contents**

The valuation techniques used to measure fair value for the items in the table above are as follows:

**Loans held for sale** Loans held for sale are carried at the lower of cost or fair value based on product pools. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. Therefore, loans held for sale subjected to nonrecurring fair value adjustments are classified as Level 2.

**Loans** Nonrecurring fair value adjustments to loans reflect full or partial write-downs that are based on the loan's observable market price or current appraised value of the collateral in accordance with SFAS 114, *Accounting by Creditors for Impairment of a Loan*. Since the market for impaired loans is not active, loans subjected to nonrecurring fair value adjustments based on the loan's observable market price are generally classified as Level 2. Loans subjected to nonrecurring fair value adjustments based on the current appraised value of the collateral may be classified as Level 2 or Level 3 depending on the type of asset and the inputs to the valuation. When appraisals are used to determine impairment and these appraisals are based on a market approach incorporating a dollar-per-square-foot multiple, the related loans are classified as Level 2. If the appraisals require significant adjustments to market-based valuation inputs or apply an income approach based on unobservable cash flows to measure fair value, the related loans subjected to nonrecurring fair value adjustments are typically classified as Level 3 due to the fact that Level 3 inputs are significant to the fair value measurement.

During the three and six months ended June 30, 2008, BancGroup recognized adjustments related to certain assets that are measured at fair value on a nonrecurring basis (i.e. loans and loans held for sale). Approximately \$58 million and \$96 million of losses related to loans were recognized as either charge-offs or specific allocations of the allowance for loan losses for the three and six months ended June 30, 2008, respectively.

During the three months ended June 30, 2008, the Company recorded approximately \$13.9 million of net gains due to the recovery of previous lower of cost or fair value adjustments on loans held for sale. The gains were substantially offset by net losses of approximately \$13.2 million on related call options.

During the six months ended June 30, 2008, the Company recorded approximately \$15.9 million of net losses due to lower of cost or fair value adjustments on loans held for sale. The losses were substantially offset by net gains of approximately \$14.3 million on related call options.

**Note 5: Securities**

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

	Carrying Value at June 30, 2008	Carrying Value at December 31, 2007 (In thousands)
<b>Securities available for sale:</b>		
Mortgage-backed securities and other pass-through securities of GSE's	\$ 698,055	\$ 655,636
Collateralized mortgage obligations	2,224,933	2,404,914
Obligations of state and political subdivisions	352,406	371,930
Corporate notes		6,819
Federal Reserve and FHLB stock and other	177,292	241,983
<b>Total securities available for sale</b>	<b>3,452,686</b>	<b>3,681,282</b>
<b>Held to maturity securities:</b>		
U.S. Treasury securities and obligations of GSE's	500	500
Mortgage-backed securities of GSE's	432	486
Collateralized mortgage obligations	8	9
Obligations of state and political subdivisions	233	233

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

Total held to maturity securities	<b>1,173</b>	1,228
Total securities	<b>\$ 3,453,859</b>	\$ 3,682,510

**Table of Contents**

During the second quarter of 2008, the Company did not sell any securities and purchased approximately \$128 million in new securities, excluding transactions in Federal Home Loan Bank of Atlanta (FHLB) stock. In April 2008, the Company recorded a gain of \$3.0 million from the early termination of a \$250 million resell agreement. In connection with its conversion to a state chartered bank, during the second quarter of 2008, Colonial Bank surrendered approximately 1.2 million shares of Federal Reserve Bank Stock at a par value of \$61.3 million plus accrued dividends.

During the first quarter of 2008, the Company sold approximately \$217 million in securities and purchased approximately \$219 million in new securities, excluding transactions in FHLB stock.

The following table reflects gross unrealized losses and fair values of the Company's available for sale and held to maturity securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2008:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Mortgage-backed and other pass-through securities of GSE's	\$ 437,260	\$ (5,143)	\$ 12,362	\$ (476)	\$ 449,622	\$ (5,619)
Collateralized mortgage obligations	1,244,828	(130,303)	643,099	(110,470)	1,887,927	(240,773)
Obligations of state and political subdivisions	286,713	(7,815)			286,713	(7,815)
Subtotal, debt securities	1,968,801	(143,261)	655,461	(110,946)	2,624,262	(254,207)
Equity securities	189	(46)	1,499	(3,730)	1,688	(3,776)
Total temporarily impaired securities	\$ 1,968,990	\$ (143,307)	\$ 656,960	\$ (114,676)	\$ 2,625,950	\$ (257,983)

The following table reflects gross unrealized losses and fair values of the Company's available for sale and held to maturity securities, aggregated by category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Mortgage-backed and other pass-through securities of GSE's	\$ 105	\$	\$ 44,720	\$ (597)	\$ 44,825	\$ (597)
Collateralized mortgage obligations	900,225	(17,757)	584,327	(12,190)	1,484,552	(29,947)
Obligations of state and political subdivisions	71,518	(496)			71,518	(496)
Subtotal, debt securities	971,848	(18,253)	629,047	(12,787)	1,600,895	(31,040)
Equity securities	3,670	(1,560)			3,670	(1,560)
Total temporarily impaired securities	\$ 975,518	\$ (19,813)	\$ 629,047	\$ (12,787)	\$ 1,604,565	\$ (32,600)

The debt securities shown in the previous tables consist of collateralized mortgage obligations (CMO's) and mortgage-backed securities of Government Sponsored Entities (GSE's), AAA-rated private CMO's, and obligations of state and political subdivisions. As of June 30, 2008 and December 31, 2007, there were 302 and 129 debt securities, respectively, carried at an unrealized loss relating to the level of interest rates prevailing in

**Table of Contents**

the market. Illiquid capital markets have negatively impacted the Company's highly-rated investment securities portfolio, which is not reflective of the portfolio's underlying performance. Because of the creditworthiness of the issuers and because the future direction of interest rates is unknown, the impairments are deemed to be temporary. The severity and duration of such impairments are determined by the level of interest rates as well as the liquidity of the capital markets. Additionally, BancGroup has the ability to retain these securities until recovery of unrealized loss or maturity when full repayment would be received. There are no known current funding needs which would require their liquidation.

**Note 6: Loans**

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

	June 30, 2008	December 31, 2007
	(In thousands)	
Commercial, financial and agricultural	\$ 1,660,417	\$ 1,506,986
Commercial real estate	4,989,456	5,012,773
Real estate construction	5,784,204	6,296,262
Residential real estate	2,608,066	2,673,823
Consumer and other	443,810	452,642
Total loans	15,485,953	15,942,486
Less: unearned income	(17,121)	(19,308)
Total loans, net of unearned income	\$ 15,468,832	\$ 15,923,178

**Note 7: Allowance for Loan Losses**

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

	Six Months Ended June 30, 2008 (In thousands)
Balance, January 1	\$ 238,845
Provision charged to income	114,543
Loans charged off	(109,191)
Recoveries	2,812
Balance, June 30	\$ 247,009

**Note 8: Commitments and Contingent Liabilities****Guarantees**

Standby letters of credit are contingent commitments issued by Colonial Bank (the Bank) generally to guarantee the performance of a customer to a third party. A financial standby letter of credit is a commitment by Colonial Bank to guarantee a customer's repayment of an outstanding loan or debt instrument. In a performance standby letter of credit, Colonial Bank guarantees a customer's performance under a contractual nonfinancial obligation for which the Bank receives a fee. These guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The Bank holds various assets as collateral supporting those commitments for which collateral is deemed necessary. At inception, these commitments are recorded on the balance sheet at fair value. The fair value of the commitment typically approximates the fee received from the customer for issuing such commitments. These fees are deferred and are recognized over the commitment period. The amounts recorded for deferred fees as of June 30, 2008 and December 31, 2007 were \$698,000 and \$823,000, respectively. At June 30, 2008, Colonial Bank had standby





## **Table of Contents**

letters of credit outstanding with maturities of generally one year or less. The maximum potential amount of future undiscounted payments the Bank could be required to make under outstanding standby letters of credit at June 30, 2008 was \$254 million.

In connection with the sale of certain loans and related assets, Colonial makes representations, warranties and indemnifications to the purchasers thereof. At June 30, 2008, Colonial's maximum potential amount of future undiscounted payments under these representations, warranties and indemnifications was \$14 million. There were no potential future payments related to these transactions at December 31, 2007.

### ***Contingencies***

BancGroup and its subsidiaries are, from time to time, defendants in legal actions arising from normal business activities. Management does not anticipate that the outcome of any litigation presently pending at June 30, 2008 will have a material adverse effect on BancGroup's consolidated financial statements or results of operations.

### **Note 9: Derivatives**

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

#### ***Interest Rate Swaps***

##### ***Fair Value Hedges***

During the first quarter of 2008, BancGroup entered into interest rate swaps with an aggregate notional amount of \$250 million to hedge fixed rate subordinated debt. The fair value of these swaps as of June 30, 2008 was a loss of approximately \$7.5 million. There were no hedging gains or losses resulting from hedge ineffectiveness recognized during the six months ended June 30, 2008, or June 30, 2007.

The Company has established collateral agreements with its swap counterparties that provide for exchanges of marketable securities or cash to collateralize either party's net gains. At June 30, 2008, \$7.1 million in collateral posted to a swap counterparty was outstanding and has been netted against the swap fair value loss of \$7.5 million in other liabilities in the Consolidated Statement of Condition.

##### ***Cash Flow Hedges***

During the second quarter of 2006, the Company terminated interest rate swaps which were used as cash flow hedges of loans. The hedged forecasted transactions were considered probable of occurring, therefore the net loss remained in accumulated other comprehensive loss and was reclassified into earnings in the same periods during which the hedged forecasted transactions affected earnings. For the six months ended June 30, 2008, losses reclassified into earnings totaled \$3.2 million, leaving no further losses to be reclassified. There were no recognized cash flow hedging gains or losses resulting from hedge ineffectiveness for the six months ended June 30, 2008, or June 30, 2007.

#### ***Commitments to Originate and Sell Mortgage Loans***

In connection with its retail mortgage loan production activities, the Company routinely enters into short-term commitments to fund residential mortgage loans (commonly referred to as interest rate locks). The Company utilizes forward sales commitments to economically mitigate the risk of potential decreases in the value of the loans that would result from the exercise of the loan commitments. The notional amounts of these mortgage loan origination commitments and the related forward sales commitments were approximately \$26.6 million at June 30, 2008. The fair value of the origination commitments was a gain of approximately \$234,000 at June 30, 2008, which was partially offset by a loss of approximately \$66,000 on the related sales commitments.

**Table of Contents**

BancGroup has executed individual forward sales commitments on the retail portion of loans held for sale. The notional value of these forward sales commitments at June 30, 2008 was \$74.7 million, none of which was designated as a hedge. The fair value of the sales commitments was a loss of approximately \$1.2 million at June 30, 2008.

**Options**

Colonial sells call options related to its interests in short-term participations in mortgage loans. Generally, the change in fair value of the participation interests offsets the change in fair value of the call options. The notional amount of the call options at June 30, 2008 was \$1.9 billion. The call options are not designated as hedges of the participation interests. The fair value of the call options was a loss of \$10.1 million as of June 30, 2008.

BancGroup occasionally enters into over-the-counter option contracts on bonds in its securities portfolio. However, there were no such option contracts outstanding at June 30, 2008.

**Note 10: Short-Term Borrowings**

Short-term borrowings are summarized as follows:

	June 30, 2008	December 31, 2007
	(In thousands)	
Repurchase agreements (retail)	\$ 525,724	\$ 568,721
Federal funds purchased	135,000	
<b>Total</b>	<b>\$ 660,724</b>	<b>\$ 568,721</b>

**Note 11: Long-Term Debt**

Long-term debt is summarized as follows:

	June 30, 2008	December 31, 2007
	(In thousands)	
Variable rate subordinated debentures	\$ 7,725	\$ 7,725
Subordinated notes	612,134	378,709
Junior subordinated debt	108,248	108,256
FHLB borrowings	3,300,756	3,513,997
Capital lease obligations	16,603	15,149
<b>Total</b>	<b>\$ 4,037,741</b>	<b>\$ 4,023,836</b>

During the second quarter of 2008, the Company paid off \$114 million of FHLB borrowings with an interest rate of 4.66% and repurchased \$8.1 million of its 8% subordinated notes due March 15, 2009.

During the first quarter of 2008, the Company issued \$250 million of 8.875% subordinated notes due March 15, 2038. The notes qualify as Tier II regulatory capital. Colonial may redeem the notes in whole or in part on or after March 15, 2013 in accordance with Federal Reserve guidelines. Colonial also paid off a \$100 million FHLB borrowing at a rate of 4.68%; redeemed \$7.7 million of variable rate subordinated debentures; and repurchased \$2 million of its 8% subordinated notes due March 15, 2009. The subordinated notes maturing in March 2009 ceased to qualify as regulatory capital in March 2008.



**Table of Contents**

There have been no other material changes in BancGroup's long-term debt. Refer to the Company's 2007 Annual Report on Form 10-K for additional information.

**Note 12: Employee Benefit Plans****Pension Plan**

BancGroup and its subsidiaries sponsor a pension plan that covers most employees who have met certain age and length of service requirements. The plan provides benefits based on final average earnings, covered compensation, and years of benefit service. On December 31, 2005, BancGroup closed the pension plan to new employees and set the compensation amount and years of service for the future benefits calculation for participants. Actuarial computations for financial reporting purposes are based on the projected unit credit method. The measurement date is December 31. Based on current actuarial projections, BancGroup will not be required to, nor does it expect to, make a contribution to the plan in 2008.

The following table reflects the components of net periodic benefit income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands)			
<b>Components of net periodic benefit income:</b>				
Interest cost	\$ 929	\$ 727	\$ 1,857	\$ 1,454
Expected return on plan assets	(1,529)	(1,104)	(3,057)	(2,209)
Net periodic benefit income	\$ (600)	\$ (377)	\$ (1,200)	\$ (755)

**401(k) Savings Plan**

BancGroup sponsors a 401(k) savings plan which provides certain retirement, death, disability and employment benefits to all eligible employees and qualifies as a deferred arrangement under Section 401(k) of the Internal Revenue Code. Participants make elective contributions into a number of available investment options through payroll deductions, including the option to purchase BancGroup common stock. On April 16, 2008, the Company's Board of Directors approved the registration of 10 million additional shares of the Company's common stock that may be issued under the 401(k) savings plan. On May 5, 2008, the Company filed the related registration statement with the Securities and Exchange Commission registering the new shares.

**Note 13: Stock-Based Compensation**

Total compensation cost for stock-based compensation awards (both stock options and restricted stock awards) for the three months ended June 30, 2008 and 2007 was \$1.3 million and \$594,000, respectively. The related income tax benefit was \$437,000 and \$79,000, respectively. Total compensation cost for stock-based compensation awards for the six months ended June 30, 2008 and 2007 was \$2.6 million and \$2.0 million, respectively. The related income tax benefit was \$882,000 and \$446,000, respectively.

The following table summarizes BancGroup's stock option activity since December 31, 2007:

	Options	Weighted Average Exercise Price
Outstanding at December 31, 2007	3,578,070	\$ 19.12
Granted	1,094,651	11.33
Exercised	(50,700)	12.14
Cancelled	(235,723)	17.85

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

Outstanding at June 30, 2008	4,386,298	\$	17.35
------------------------------	-----------	----	-------

**Table of Contents**

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

	Six months ended June 30, 2008
Expected option term	5.33 years
Weighted average expected volatility	31.15%
Weighted average risk-free interest rate	3.06%
Weighted average expected annual dividend yield	4.50%

The following table summarizes BancGroup's restricted stock activity since December 31, 2007:

	Restricted Stock	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2007	518,166	\$ 23.21
Granted	627,355	11.19
Vested	(1,220)	24.39
Cancelled	(25,927)	14.99
Nonvested at June 30, 2008	1,118,374	\$ 16.66

**Note 14: Earnings Per Share**

The following table reflects a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation:

	Three Months Ended June 30,			Six Months Ended June 30,		
	Net (Loss) Income	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
(In thousands, except per share amounts)						
<b>2008</b>						
Basic EPS	\$ (8,956)	188,730	\$ (0.05)	\$ 15,841	172,844	\$ 0.09
Effect of dilutive instruments:						
Options and nonvested restricted stock					228	
Diluted EPS	\$ (8,956)	188,730	\$ (0.05)	\$ 15,841	173,072	\$ 0.09
<b>2007</b>						
Basic EPS	\$ 66,119	154,217	\$ 0.43	\$ 102,598	153,268	\$ 0.67
Effect of dilutive instruments:						
Options and nonvested restricted stock		959			1,068	
Diluted EPS	\$ 66,119	155,176	\$ 0.43	\$ 102,598	154,336	\$ 0.66

The above calculations exclude awards that could potentially dilute basic EPS in the future but were antidilutive for the periods presented. The number of such awards excluded was approximately 5,505,000 and 4,516,000 for the three and six months ended June 30, 2008, respectively, and 1,705,000 and 1,643,000 for the three and six months ended June 30, 2007, respectively.





**Table of Contents**

**Note 15: Income Taxes**

In accordance with FASB Interpretation No. 48, *Accounting for Uncertainty of Income Taxes and Interpretation of FASB Statement No. 109*, BancGroup has recorded a liability for unrecognized tax benefits and the related interest and penalties at June 30, 2008 totaling \$30.4 million compared to \$26.6 million at December 31, 2007. While the Company expects to settle various state tax audits within the next twelve months, the change in the unrecognized tax benefit is not expected to be material to the financial statements.

**Note 16: Segment Information**

The Company has six reportable segments for management reporting. Each regional bank segment consists of commercial lending and full service branches in its geographic region with its own management team. The branches provide a full range of traditional banking products as well as financial planning and mortgage banking services. The mortgage warehouse segment headquartered in Orlando, Florida provides funding to mortgage origination companies. The Company reports Corporate/Treasury/Other which includes the investment securities portfolio, nondeposit funding activities including long-term debt, short-term liquidity and balance sheet risk management including derivative hedging activities, the parent company's activities, intercompany eliminations and certain support activities not currently allocated to the aforementioned segments. In addition, Corporate/Treasury/Other includes income from bank-owned life insurance, income and expenses from various nonbank subsidiaries, joint ventures and equity investments, merger related expenses and the unallocated portion of the Company's financial planning business.

**Table of Contents**

The results for these segments are based on BancGroup's management reporting process, which assigns balance sheet and income statement items to each segment. Unlike financial reporting, there is no authoritative guidance for management reporting equivalent to generally accepted accounting principles. Colonial uses an internal funding methodology to assign funding costs to assets and earning credits to liabilities as well as an internal capital allocation methodology with an offset in Corporate/Treasury/Other. The provision for loan losses included in each banking segment is based on their actual net charge-off experience. The provision for loan losses included in the mortgage warehouse segment was based on an allocation of the Company's loan loss reserve. Certain back office support functions are allocated to each segment on the basis most applicable to the function being allocated. The management reporting process measures the performance of the defined segments based on the Company's management structure and is not necessarily comparable with similar information for other financial services companies. If the management structure and/or allocation process changes, allocations, transfers and assignments may change.

	Florida Regional Bank	Florida Mortgage Warehouse	Alabama Regional Bank	Georgia Regional Bank	Nevada Regional Bank	Texas Regional Bank	Corporate/ Treasury Other	Consolidated BancGroup
(In thousands)								
<b>Three Months Ended June 30, 2008</b>								
Net interest income before intersegment income / expense	\$ 72,890	\$ 60,543	\$ 9,364	\$ 13,544	\$ 11,028	\$ 20,334	\$ (13,279)	\$ 174,424
Intersegment interest income / expense	4,154	(25,841)	18,505	(3,647)	(1,394)	(5,739)	13,962	
Net interest income	77,044	34,702	27,869	9,897	9,634	14,595	683	174,424
Provision for loan losses	55,893	(45)	5,867	2,933	8,107	385	5,860	79,000
Noninterest income	18,202	3,019	13,442	6,408	1,981	1,539	11,132	55,723
Noninterest expense	61,262	5,140	21,748	10,689	6,777	7,788	50,763	164,167
Minority interest expense/REIT preferred dividends							5,336	5,336
Income/(loss) before income taxes	\$ (21,909)	\$ 32,626	\$ 13,696	\$ 2,683	\$ (3,269)	\$ 7,961	\$ (50,144)	(18,356)
Income taxes								(9,400)
<b>Net Loss</b>								<b>\$ (8,956)</b>
Total Assets	\$ 11,486,888	\$ 4,534,178	\$ 4,240,404	\$ 1,341,072	\$ 1,061,086	\$ 1,692,255	\$ 1,675,408	\$ 26,031,291
Total Deposits	\$ 9,932,324	\$ 594,358	\$ 4,134,160	\$ 724,068	\$ 701,696	\$ 741,555	\$ 1,521,004	\$ 18,349,165
<b>Three Months Ended June 30, 2007</b>								
Net interest income before intersegment income / expense	\$ 80,791	\$ 49,704	\$ 17,024	\$ 21,086	\$ 14,273	\$ 26,312	\$ (18,973)	\$ 190,217
Intersegment interest income / expense	876	(28,545)	17,791	(8,034)	(2,204)	(10,940)	31,056	
Net interest income	81,667	21,159	34,815	13,052	12,069	15,372	12,083	190,217
Provision for loan losses	2,026	45	4,673	742	17	136	(1,534)	6,105
Noninterest income	18,129	6,919	12,902	4,819	1,938	1,725	12,349	58,781
Noninterest expense	51,600	2,140	20,932	5,697	6,303	7,629	47,183	141,484
Minority interest expense/REIT preferred dividends							2,312	2,312
Income/(loss) before income taxes	\$ 46,170	\$ 25,893	\$ 22,112	\$ 11,432	\$ 7,687	\$ 9,332	\$ (23,529)	99,097
Income taxes								32,978
Net Income								\$ 66,119
Total Assets	\$ 11,735,373	\$ 3,007,608	\$ 4,135,506	\$ 1,410,015	\$ 978,519	\$ 1,557,473	\$ 998,468	\$ 23,822,962
Total Deposits	\$ 9,563,386	\$ 749,983	\$ 4,095,146	\$ 781,475	\$ 709,751	\$ 702,839	\$ 481,483	\$ 17,084,063

**Table of Contents**

	Florida Regional Bank	Florida Mortgage Warehouse	Alabama Regional Bank	Georgia Regional Bank	Nevada Regional Bank	Texas Regional Bank	Corporate/ Treasury Other	Consolidated BancGroup
(In thousands)								
<b>Six Months Ended June 30, 2008</b>								
Net interest income before intersegment income / expense	\$ 147,113	\$ 126,812	\$ 21,514	\$ 29,254	\$ 23,569	\$ 43,295	\$ (35,509)	\$ 356,048
Intersegment interest income / expense	6,702	(60,377)	37,496	(10,189)	(4,499)	(15,338)	46,205	
Net interest income	153,815	66,435	59,010	19,065	19,070	27,957	10,696	356,048
Provision for loan losses	79,015	147	9,207	8,831	8,206	877	8,260	114,543
Noninterest income	36,092	5,690	26,898	12,265	3,592	2,989	25,944	113,470
Noninterest expense	122,277	12,713	43,622	20,250	13,618	16,188	99,477	328,145
Minority interest expense/REIT preferred dividends							10,672	10,672
Income/(loss) before income taxes	\$ (11,385)	\$ 59,265	\$ 33,079	\$ 2,249	\$ 838	\$ 13,881	\$ (81,769)	16,158
Income taxes								317
<b>Net Income</b>								<b>\$ 15,841</b>
<b>Six Months Ended June 30, 2007</b>								
Net interest income before intersegment income / expense	\$ 166,066	\$ 86,680	\$ 37,736	\$ 41,233	\$ 27,597	\$ 48,971	\$ (38,121)	\$ 370,162
Intersegment interest income / expense	467	(49,053)	32,628	(15,622)	(4,098)	(20,556)	56,234	
Net interest income	166,533	37,627	70,364	25,611	23,499	28,415	18,113	370,162
Provision for loan losses	2,471	(291)	5,204	1,802	44	301	(1,176)	8,355
Noninterest income	36,127	14,403	25,660	7,115	3,832	3,374	(16,511)	74,000
Noninterest expense	102,931	4,242	41,552	11,694	12,345	14,951	91,910	279,625
Minority interest expense/REIT preferred dividends							2,312	2,312
Income/(loss) before income taxes	\$ 97,258	\$ 48,079	\$ 49,268	\$ 19,230	\$ 14,942	\$ 16,537	\$ (91,444)	153,870
Income taxes								51,272
<b>Net Income</b>								<b>\$ 102,598</b>

**Table of Contents**

**Note 17: Capital Stock**

***Common Stock Offering***

On April 25, 2008, the Company completed a public common stock offering of 43.7 million shares at \$8.00 per share for \$350 million. Colonial received proceeds of \$333.9 million, which is net of all expenses, commissions and underwriters' discounts. The Company will use the proceeds for general corporate purposes as well as investment in subsidiaries.

***Dividend Reinvestment and Common Stock Purchase Plan***

The Company has a dividend reinvestment and common stock purchase plan under which shareholders may automatically reinvest their cash dividends in shares of common stock as well as make optional cash purchases of common stock. On April 16, 2008, the Company's Board of Directors approved the registration of 10 million additional shares that may be issued under this plan, bringing the total authorized for issuance to 12 million shares. On May 2, 2008, the Company filed the related registration statement with the Securities and Exchange Commission registering the new shares and amending the plan.

**Note 18: Goodwill**

BancGroup tests goodwill for impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. In light of the challenging interest rate and credit environments that have persisted since late 2007, and the fact that the Company's stock has been trading below book value per share, interim impairment testing was performed at December 31, 2007, March 31, 2008 and June 30, 2008. The estimated fair values of the Company's reporting units were based on discounted cash flow models derived from internal earnings forecasts. Based on current results and expectations, BancGroup has determined that the fair values of its reporting units continue to exceed their carrying values. Therefore, management determined that no goodwill impairment charge was required as of June 30, 2008.

Due to the ongoing uncertainty in market conditions, which may continue to negatively impact the performance of BancGroup's reporting units, management will continue to monitor and evaluate the carrying value of goodwill, particularly with respect to the Florida reporting units. Earnings forecasts relating to the Company's reporting units have generally declined over the past two quarters. If market and economic conditions or business performance deteriorate further, this could increase the likelihood of the Company recording an impairment charge to the extent that the book equity value, including goodwill, exceeds the estimated fair value of the reporting unit.

## **Table of Contents**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results Of Operations**

#### **Forward-Looking Statements**

This discussion and analysis contains statements that are considered forward-looking statements within the meaning of the federal securities laws. See page 3 for additional information regarding forward-looking statements.

#### **CRITICAL ACCOUNTING POLICIES**

Those accounting policies involving significant estimates and assumptions by management which have, or could have, a material impact on the reported financial results are considered critical accounting policies. BancGroup recognizes the following as critical accounting policies: Allowance for Loan Losses, Purchase Accounting and Goodwill, Income Taxes, Consolidations and Stock-Based Compensation. Information concerning these policies is included in the *Critical Accounting Policies* section of Management's Discussion and Analysis in BancGroup's 2007 Annual Report on Form 10-K.

#### **EXECUTIVE OVERVIEW**

The Colonial BancGroup, Inc. is a \$26.0 billion financial services company providing diversified services including retail and commercial banking, wealth management services, mortgage origination and insurance products through its branch network, private banking offices and officers, ATMs and the internet as well as other distribution channels to consumers and businesses. At June 30, 2008, BancGroup's branch network consisted of 344 offices in Florida, Alabama, Georgia, Nevada and Texas.

Colonial reported a net loss of \$9.0 million for the quarter ended June 30, 2008, compared to net income of \$66.1 million for the quarter ended June 30, 2007. The Company also reported a loss per diluted share of \$0.05 for the quarter ended June 30, 2008 compared to earnings per diluted share of \$0.43 for the quarter ended June 30, 2007. For the six months ended June 30, 2008, the Company reported net income of \$15.8 million, or \$0.09 per diluted share, compared to \$102.6 million, or \$0.66 per diluted share, over the same period in 2007.

#### **REVIEW OF RESULTS OF OPERATIONS**

##### **Net Interest Income**

Net interest income is the Company's primary source of revenue. Net interest income represents the difference between interest and fee income generated from earning assets and the interest expense paid on deposits and borrowed funds. Interest rate volatility, which impacts the volume and mix of earning assets and interest bearing liabilities as well as their rates, can significantly impact net interest income. The net interest margin is fully tax equivalent net interest income expressed as a percentage of average earning assets for the period being measured. The net interest margin is presented on a fully tax equivalent basis to consistently reflect income from taxable and tax-exempt loans and securities.

Beginning in late 2007 and early 2008, the yield curve returned to a more normalized level after remaining flat or inverted since late 2005. Short-term rates were driven by rate decreases by the Federal Reserve, while long-term rates were driven by market supply and demand for debt instruments. After remaining constant at 5.25% from June 2006 to September 2007, the Federal Reserve Board lowered the Federal Funds rate 325 basis points from September 2007 to June 2008. Due to intense competition for deposits from financial services companies, cost of funds in

## Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

the financial sector have not declined in tandem with the decrease in the Federal Funds rate. The following table shows the Federal Funds rate and U.S. Treasury yield curve at each quarter end during the past five quarters.

**Table of Contents**

The Company's net interest income, on a tax equivalent basis, decreased \$15.1 million, or 7.9%, for the three months ended June 30, 2008, as compared to the same period of the prior year. The yield on average earning assets decreased 58 basis points more than the decrease in the rate on average interest bearing liabilities causing net interest margin to contract 78 basis points. The impact to net interest income caused by net interest margin contraction was mitigated by a \$3.6 billion, or a 17%, increase in average earning assets and \$333.9 million in net proceeds from the issuance of 43.7 million shares of common stock in April 2008.

For the six months ended June 30, 2008, the Company's net interest income, on a tax equivalent basis, decreased \$12 million, or 3.2%, as compared to the same period of the prior year. The yield on average earning assets decreased 50 basis points more than the decrease in the rate on average interest bearing liabilities causing net interest margin to contract 65 basis points. The impact to net interest income caused by net interest margin contraction was mitigated by a \$3.8 billion, or an 18% increase in average earning assets and \$333.9 million in net proceeds from the issuance of 43.7 million shares of common stock in April 2008.

Net interest income was negatively impacted by the 325 basis point decline in the Wall Street Journal Prime rate and the 271 basis point decline in the 1 Month LIBOR rate from June 2007 to June 2008, as approximately 64% of Colonial's earning assets for both the three and six months ended June 30, 2008 were variable, adjustable or short-term in nature. In addition, Colonial's deposit costs did not decline in tandem with the decline in prime and LIBOR rates due to intense competition for deposit dollars from financial services companies. The average cost of deposits exceeded the average Federal Funds rate by 47 and 10 basis points, respectively, for the three and six months ended June 30, 2008, as compared to average deposit costs which were 186 and 187 basis points, respectively, lower than the average Federal Funds rate for the three and six months ended June 30, 2007. The following table shows average rates for selected balance sheet categories as well as selected market rates.

**Table of Contents****Analysis Of Average Rates**

	Three Months Ended June 30,		Basis Point Increase/ (Decrease)	Six Months Ended June 30,		Basis Point Increase/ (Decrease)
	2008	2007		2008	2007	
Loans, net of unearned income	<b>6.02%</b>	7.78%	(1.76)%	<b>6.30%</b>	7.76%	(1.46)%
Loans held for sale	<b>4.64%</b>	6.86%	(2.22)%	<b>4.90%</b>	6.89%	(1.99)%
Securities	<b>5.88%</b>	5.62%	0.26%	<b>5.91%</b>	5.42%	0.49%
Resell agreements and other interest earning assets	<b>4.68%</b>	6.81%	(2.13)%	<b>4.97%</b>	6.76%	(1.79)%
Total interest earning assets	<b>5.72%</b>	7.37%	(1.65)%	<b>5.95%</b>	7.31%	(1.36)%
Interest bearing deposits	<b>3.04%</b>	4.12%	(1.08)%	<b>3.28%</b>	4.11%	(0.83)%
Total deposits	<b>2.55%</b>	3.39%	(0.84)%	<b>2.75%</b>	3.38%	(0.63)%
Wholesale borrowings	<b>4.19%</b>	5.23%	(1.04)%	<b>4.25%</b>	5.28%	(1.03)%
Total interest bearing liabilities	<b>3.32%</b>	4.39%	(1.07)%	<b>3.54%</b>	4.40%	(0.86)%
Federal Funds	<b>2.08%</b>	5.25%	(3.17)%	<b>2.65%</b>	5.25%	(2.60)%
1 Month LIBOR	<b>2.75%</b>	5.32%	(2.57)%	<b>3.05%</b>	5.32%	(2.27)%
Wall Street Journal Prime	<b>5.08%</b>	8.25%	(3.17)%	<b>5.65%</b>	8.25%	(2.60)%



**Table of Contents**

*Interest Earning Assets*

Average earning assets, as shown below, consist primarily of loans, securities, loans held for sale and securities purchased under agreements to resell (included in other earning assets below). Colonial invested a larger percentage of its funds in securities, loans held for sale, and securities purchased under agreements to resell for the three and six months ended June 30, 2008, as compared to the same periods of the prior year.

**Table of Contents**

***Average Funding***

Average funding, as shown below, consists primarily of deposits and wholesale borrowings. Average funding grew \$4 billion, or 17%, and \$4.3 billion, or 18%, for the three and six months ended June 30, 2008, respectively, as compared to the same periods of the prior year.

**Table of Contents****Average Volume and Rates****(Unaudited)**

	Three Months Ended June 30,					
	2008			2007		
	Average Volume	Interest	Rate	Average Volume	Interest	Rate
	(Dollars in thousands)					
<b>ASSETS:</b>						
Loans, net of unearned income(2)	\$ 15,797,611	\$ 236,737	6.02%	\$ 15,112,712	\$ 293,233	7.78%
Loans held for sale(2)	2,953,444	34,061	4.64%	1,881,595	32,180	6.86%
Securities(2)	3,663,516	53,897	5.88%	2,595,580	36,438	5.62%
Securities purchased under agreements to resell	2,110,183	24,814	4.73%	1,310,840	22,493	6.88%
Other interest earning assets	51,727	332	2.58%	68,127	938	5.52%
<b>Total interest earning assets(3)</b>	<b>24,576,481</b>	<b>\$ 349,841</b>	<b>5.72%</b>	<b>20,968,854</b>	<b>\$ 385,282</b>	<b>7.37%</b>
Nonearning assets(2)	2,439,659			2,128,630		
<b>Total assets</b>	<b>\$ 27,016,140</b>			<b>\$ 23,097,484</b>		
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>						
Interest bearing non-time deposits	\$ 6,308,837	\$ 22,988	1.47%	\$ 6,374,663	\$ 49,664	3.12%
Time deposits	8,022,407	80,317	4.03%	6,743,475	84,173	5.01%
Brokered time deposits	1,574,093	17,102	4.37%	410,034	5,232	5.12%
<b>Total interest bearing deposits</b>	<b>15,905,337</b>	<b>120,407</b>	<b>3.04%</b>	<b>13,528,172</b>	<b>139,069</b>	<b>4.12%</b>
Repurchase agreements	522,045	2,528	1.95%	511,175	5,327	4.18%
Federal funds purchased and other short-term borrowings	475,681	2,550	2.16%	635,665	8,404	5.30%
Long-term debt(2)	4,076,494	47,831	4.71%	3,033,776	40,858	5.40%
<b>Total interest bearing liabilities</b>	<b>20,979,557</b>	<b>\$ 173,316</b>	<b>3.32%</b>	<b>17,708,788</b>	<b>\$ 193,658</b>	<b>4.39%</b>
Noninterest bearing demand deposits	3,067,322			2,935,570		
Other liabilities(2)	265,528			161,766		
<b>Total liabilities</b>	<b>24,312,407</b>			<b>20,806,124</b>		
Minority interest/REIT preferred securities	293,058			125,416		
Shareholders' equity	2,410,675			2,165,944		
<b>Total liabilities and shareholders' equity</b>	<b>\$ 27,016,140</b>			<b>\$ 23,097,484</b>		
<b>RATE DIFFERENTIAL</b>			<b>2.40%</b>			<b>2.98%</b>
<b>NET INTEREST INCOME AND NET YIELD ON INTEREST EARNING ASSETS ON A TAX EQUIVALENT BASIS(3)</b>		<b>\$ 176,525</b>	<b>2.88%</b>		<b>\$ 191,624</b>	<b>3.66%</b>
<b>Taxable equivalent adjustments(1):</b>						
Loans		(161)			(232)	
Securities		(1,940)			(1,175)	
<b>Total taxable equivalent adjustments</b>		<b>(2,101)</b>			<b>(1,407)</b>	

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

Net interest income		<b>\$ 174,424</b>			\$ 190,217	
<b>TOTAL AVERAGE DEPOSITS:</b>						
Total interest bearing deposits	<b>\$ 15,905,337</b>	<b>\$ 120,407</b>	<b>3.04%</b>	\$ 13,528,172	\$ 139,069	4.12%
Noninterest bearing demand deposits	<b>3,067,322</b>			2,935,570		
Total average deposits	<b>\$ 18,972,659</b>	<b>\$ 120,407</b>	<b>2.55%</b>	\$ 16,463,742	\$ 139,069	3.39%
Total average deposits, excluding brokered time	<b>\$ 17,398,566</b>	<b>\$ 103,305</b>	<b>2.39%</b>	\$ 16,053,708	\$ 133,837	3.35%

- (1) Interest earned and average rates on securities and loans exempt from income taxes are reflected on a fully tax equivalent basis using a federal income tax rate of 35%, net of nondeductible interest expense.
- (2) Unrealized gains (losses) on available for sale securities, the adjustments for mark to market valuations on hedged assets and liabilities and lower of cost or fair value adjustments have been classified in either other assets or other liabilities.
- (3) Net yield on interest earning assets is calculated by taking annualized fully tax equivalent net interest income divided by average total interest earning assets.

**Table of Contents****Analysis of Interest Increases (Decreases)****(Unaudited)**

	<b>Three Months Ended June 30, 2008 Change from June 30, 2007 Attributed to(1)</b>		
	<b>Total</b>	<b>Volume</b>	<b>Rate</b>
	<b>(In thousands)</b>		
<b>INTEREST INCOME:</b>			
Loans, net of unearned income	\$ (56,496)	\$ 9,819	\$ (66,315)
Loans held for sale	1,881	12,296	(10,415)
Securities	17,459	15,772	1,687
Securities purchased under agreements to resell	2,321	9,347	(7,026)
Other interest earning assets	(606)	(107)	(499)
<b>Total interest income</b>	<b>(35,441)</b>	<b>47,127</b>	<b>(82,568)</b>
<b>INTEREST EXPENSE:</b>			
Interest bearing non-time deposits	(26,676)	(452)	(26,224)
Time deposits	(3,856)	12,620	(16,476)
Brokered time deposits	11,870	12,637	(767)
Repurchase agreements	(2,799)	43	(2,842)
Federal funds purchased and other short-term borrowings	(5,854)	(878)	(4,976)
Long-term debt	6,973	12,192	(5,219)
<b>Total interest expense</b>	<b>(20,342)</b>	<b>36,162</b>	<b>(56,504)</b>
<b>Net interest income</b>	<b>\$ (15,099)</b>	<b>\$ 10,965</b>	<b>\$ (26,064)</b>

(1) Increases (decreases) are attributed to volume changes and rate changes on the following basis: Volume Change = change in volume times old rate. Rate Change = change in rate times old volume. The Rate/Volume Change = change in volume times change in rate, and is allocated to Volume Change. Interest income decreased \$35.4 million for the three months ended June 30, 2008, as compared to the same period of the prior year. Average earning assets increased \$3.6 billion while the yield earned on those assets decreased 165 basis points. The drivers of these changes are more fully described in the paragraphs below.

For the three months ended June 30, 2008, interest income on loans decreased \$56.5 million, as compared to the same period of the prior year. The decrease was primarily due to the decrease in the prime lending rate and an increase in average nonperforming loans which resulted in the average yield earned on loans decreasing 176 basis points.

Interest income on loans held for sale increased \$1.9 million for the three months ended June 30, 2008, as compared to the same period of the prior year. Loans held for sale is comprised of three elements: short-term participations in mortgage loans, retail mortgage loans and other loans held for sale. The primary driver of the increase in interest income on loans held for sale was the average volume increase of \$1.1 billion, or 57%, primarily from growth in short-term participations in mortgage loans from the Company's mortgage warehouse division. The yield on loans held for sale is influenced by the prevailing market rates which were lower in the three months ended June 30, 2008 than in the same period of the prior year.

Interest income on securities increased \$17.5 million for the three months ended June 30, 2008, as compared to the same period of the prior year. The increase was primarily the result of a 26 basis point increase in yield on the average balances as well as a \$1.1 billion, or 41%, increase in average volume. The Company restructured its securities portfolio at the beginning of the second quarter of 2007, selling approximately one-third of the total portfolio and reinvesting the proceeds into higher yielding securities.



**Table of Contents**

For the three months ended June 30, 2008, interest income from securities purchased under agreements to resell increased \$2.3 million, as compared to the same period of the prior year. The primary driver of the increase was an \$800 million, or 61%, increase in average volume. The growth in average volume was the result of growth in the Company's mortgage warehouse division. The yield on securities purchased under agreements to resell is influenced by the prevailing market rates which were lower in the three months ended June 30, 2008 than in the same period of the prior year.

Interest expense decreased approximately \$20.3 million for the three months ended June 30, 2008, as compared to the same period of the prior year. The decrease in interest expense was driven primarily by a 107 basis points decrease in the cost of average interest bearing liabilities which was partially offset by a \$3.3 billion, or 18%, increase in average interest bearing liabilities. Including the impact of average noninterest bearing deposits, which increased \$132 million, average funding costs decreased 86 basis points to 2.90%. The drivers of the decrease in funding costs are described in the paragraphs below.

For the three months ended June 30, 2008, interest expense on interest bearing non-time deposits decreased \$26.7 million while interest expense on time deposits increased \$8 million, as compared to the same period of the prior year. The decrease in interest expense for non-time deposits was due to a rate reduction of 165 basis points while the increase in interest expense on time deposits was due to an increase in average volume of \$2.4 billion. The growth of time deposits is attributable to customer preference for higher rate products, increased competition for deposits and increased use of brokered time deposits as a funding source.

For the three months ended June 30, 2008, interest expense on wholesale borrowings decreased \$1.7 million, as compared to the same period of the prior year. The decrease in interest expense was primarily caused by a decrease of 104 basis points in the cost of average wholesale borrowings which was partially offset by an increase of \$894 million in average wholesale borrowings. The decline in the cost of average wholesale borrowings was the result of the Company replacing higher rate short-term and long-term borrowings with lower cost long-term debt and the repricing of variable rate wholesale borrowings.

**Table of Contents****Average Volume and Rates****(Unaudited)**

	2008			Six Months Ended June 30, 2007		
	Average Volume	Interest	Rate	Average Volume	Interest	Rate
(Dollars in thousands)						
<b>ASSETS:</b>						
Loans, net of unearned income(2)	\$ 15,895,842	\$ 498,176	6.30%	\$ 15,230,363	\$ 586,707	7.76%
Loans held for sale(2)	3,057,090	74,458	4.90%	1,585,954	54,161	6.89%
Securities(2)	3,670,331	108,509	5.91%	2,928,898	79,443	5.42%
Securities purchased under agreements to resell	2,112,696	53,073	5.05%	1,185,365	40,457	6.87%
Other interest earning assets	85,978	1,323	3.10%	82,486	2,109	5.15%
<b>Total interest earning assets(3)</b>	<b>24,821,937</b>	<b>\$ 735,539</b>	<b>5.95%</b>	<b>21,013,066</b>	<b>\$ 762,877</b>	<b>7.31%</b>
Nonearning assets(2)	2,511,054			2,062,770		
<b>Total assets</b>	<b>\$ 27,332,991</b>			<b>\$ 23,075,836</b>		
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>						
Interest bearing non-time deposits	\$ 6,459,247	\$ 55,622	1.73%	\$ 6,344,391	\$ 98,145	3.12%
Time deposits	7,755,201	166,158	4.31%	6,648,503	164,747	5.00%
Brokered time deposits	1,583,487	36,133	4.59%	365,409	9,261	5.11%
<b>Total interest bearing deposits</b>	<b>15,797,935</b>	<b>257,913</b>	<b>3.28%</b>	<b>13,358,303</b>	<b>272,153</b>	<b>4.11%</b>
Repurchase agreements	533,131	6,233	2.35%	636,621	13,882	4.40%
Federal funds purchased and other short-term borrowings	927,821	14,142	3.07%	898,468	23,681	5.32%
Long-term debt(2)	4,080,255	96,941	4.77%	2,979,704	80,876	5.46%
<b>Total interest bearing liabilities</b>	<b>21,339,142</b>	<b>\$ 375,229</b>	<b>3.54%</b>	<b>17,873,096</b>	<b>\$ 390,592</b>	<b>4.40%</b>
Noninterest bearing demand deposits	3,067,268			2,858,401		
Other liabilities(2)	287,537			164,173		
<b>Total liabilities</b>	<b>24,693,947</b>			<b>20,895,670</b>		
Minority interest/REIT preferred securities	293,058			63,054		
Shareholders' equity	2,345,986			2,117,112		
<b>Total liabilities and shareholders' equity</b>	<b>\$ 27,332,991</b>			<b>\$ 23,075,836</b>		
<b>RATE DIFFERENTIAL</b>			<b>2.41%</b>			
<b>NET INTEREST INCOME AND NET YIELD ON INTEREST EARNING ASSETS ON A TAX EQUIVALENT BASIS(3)</b>		<b>\$ 360,310</b>	<b>2.91%</b>	<b>\$ 372,285</b>	<b>3.56%</b>	
<b>Taxable equivalent adjustments(1):</b>						
Loans		(356)			(379)	
Securities		(3,906)			(1,744)	
<b>Total taxable equivalent adjustments</b>		<b>(4,262)</b>			<b>(2,123)</b>	



Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

Net interest income		<b>\$ 356,048</b>			\$ 370,162	
<b>TOTAL AVERAGE DEPOSITS:</b>						
Total interest bearing deposits	<b>\$ 15,797,935</b>	<b>\$ 257,913</b>	<b>3.28%</b>	\$ 13,358,303	\$ 272,153	4.11%
Noninterest bearing demand deposits	<b>3,067,268</b>			2,858,401		
Total average deposits	<b>\$ 18,865,203</b>	<b>\$ 257,913</b>	<b>2.75%</b>	\$ 16,216,704	\$ 272,153	3.38%
Total average deposits, excluding brokered time	<b>\$ 17,281,716</b>	<b>\$ 221,780</b>	<b>2.58%</b>	\$ 15,851,295	\$ 262,892	3.34%

- (1) Interest earned and average rates on securities and loans exempt from income taxes are reflected on a fully tax equivalent basis using a federal income tax rate of 35%, net of nondeductible interest expense.
- (2) Unrealized gains (losses) on available for sale securities, the adjustments for mark to market valuations on hedged assets and liabilities and lower of cost or fair value adjustments have been classified in either other assets or other liabilities.
- (3) Net yield on interest earning assets is calculated by taking annualized fully tax equivalent net interest income divided by average total interest earning assets.

**Table of Contents**

	Six Months Ended June 30, 2008 Change from June 30, 2007 Attributed to(1)		
	Total	Volume (In thousands)	Rate
<b>INTEREST INCOME:</b>			
Loans, net of unearned income	\$ (88,531)	\$ 21,737	\$ (110,268)
Loans held for sale	20,297	35,948	(15,651)
Securities	29,066	21,890	7,176
Securities purchased under agreements to resell	12,616	23,314	(10,698)
Other interest earning assets	(786)	53	(839)
<b>Total interest income</b>	<b>(27,338)</b>	<b>102,942</b>	<b>(130,280)</b>
<b>INTEREST EXPENSE:</b>			
Interest bearing non-time deposits	(42,523)	1,208	(43,731)
Time deposits	1,411	24,160	(22,749)
Brokered time deposits	26,872	27,814	(942)
Repurchase agreements	(7,649)	(1,177)	(6,472)
Federal funds purchased and other short-term borrowings	(9,539)	486	(10,025)
Long-term debt	16,065	26,260	(10,195)
<b>Total interest expense</b>	<b>(15,363)</b>	<b>78,751</b>	<b>(94,114)</b>
<b>Net interest income</b>	<b>\$ (11,975)</b>	<b>\$ 24,191</b>	<b>\$ (36,166)</b>

(1) Increases (decreases) are attributed to volume changes and rate changes on the following basis: Volume Change = change in volume times old rate. Rate Change = change in rate times old volume. The Rate/Volume Change = change in volume times change in rate, and is allocated to Volume Change. Interest income decreased \$27.3 million for the six months ended June 30, 2008, as compared to the same period of the prior year. Average earning assets increased \$3.8 billion while the yield earned on those assets decreased 136 basis points. The drivers of these changes are more fully described in the paragraphs below.

For the six months ended June 30, 2008, interest income on loans decreased \$88.5 million, as compared to the same period of the prior year. The decrease was primarily due to the decrease in the prime lending rate and an increase in average nonperforming loans which resulted in the average yield earned on loans decreasing 146 basis points.

Interest income on loans held for sale increased \$20.3 million for the six months ended June 30, 2008, as compared to the same period of the prior year. The primary driver of the increase in interest income on loans held for sale was the average volume increase of \$1.5 billion, or 93%, primarily from growth in the Company's mortgage warehouse division. The yield on loans held for sale is influenced by the prevailing market rates which were lower in the six months ended June 30, 2008 than in the same period of the prior year.

Interest income on securities increased \$29.1 million for the six months ended June 30, 2008, as compared to the same period of the prior year. The increase was primarily the result of a \$741 million, or 25%, increase in average volume as well as a 49 basis point increase in yield on the average balances. The Company restructured its securities portfolio at the beginning of the second quarter of 2007, selling approximately one-third of the total portfolio and reinvesting the proceeds into higher yielding securities.

For the six months ended June 30, 2008, interest income from securities purchased under agreements to resell increased \$12.6 million, as compared to the same period of the prior year. The primary driver of the increase was a \$927 million, or 78%, increase in average volume. The growth in average volume was the result of growth in the Company's mortgage warehouse division. The yield on securities purchased under agreements to resell is influenced by the prevailing market rates which were lower in the six months ended June 30, 2008 than in the same period of the prior year.



## **Table of Contents**

Interest expense decreased approximately \$15.4 million for the six months ended June 30, 2008, as compared to the same period of the prior year. The decrease in interest expense was driven primarily by an 86 basis points decrease in the cost of average interest bearing liabilities which was partially offset by a \$3.5 billion, or 19%, increase in average interest bearing liabilities. Including the impact of average noninterest bearing deposits, which increased \$209 million, average funding costs decreased 71 basis points to 3.09%. The drivers of the decrease in funding costs are described in the paragraphs below.

For the six months ended June 30, 2008, interest expense on interest bearing non-time deposits decreased \$42.5 million while interest expense on time deposits increased \$28.3 million, as compared to the same period of the prior year. The decrease in interest expense for non-time deposits was due to a rate reduction of 139 basis points while the increase in interest expense on time deposits was due to an increase in average volume of \$2.3 billion. The growth of time deposits is attributable to customer preference for higher rate products, increased competition for deposits and increased use of brokered time deposits as a funding source.

For the six months ended June 30, 2008, interest expense on wholesale borrowings decreased \$1.1 million, as compared to the same period of the prior year. The decrease in interest expense was primarily caused by a decrease of 103 basis points in the costs of average wholesale borrowings which was partially offset by an increase of \$1.0 billion in average wholesale borrowings. The decline in the cost of average wholesale borrowings was the result of the Company replacing higher rate short-term and long-term borrowings with lower cost long-term debt and the repricing of variable rate wholesale borrowings.

## **Loan Loss Provision**

The real estate markets in the U.S. have deteriorated at an accelerated pace over recent quarters, resulting in increased credit losses for many financial institutions. Many banks, including Colonial, have taken steps to increase reserve levels in response to these changing market conditions. Colonial's provision for loan losses for the three and six months ended June 30, 2008 was \$79.0 million and \$114.5 million, respectively, compared to \$6.1 million and \$8.4 million for the same periods in 2007. Net charge-offs for the three and six months ended June 30, 2008 were \$72.8 million and \$106.4 million, or an annualized 1.85% and 1.35% as a percent of average loans, respectively, compared to \$7.6 million and \$9.8 million, or an annualized 0.20% and 0.13% as a percent of average loans, respectively, for the same periods in 2007. BancGroup's allowance for loan losses was 1.60% of period end net loans at June 30, 2008 compared to 1.50% at December 31, 2007 and 1.15% at June 30, 2007.

**Table of Contents****Noninterest Income**

The following table shows the dollar and percentage change in noninterest income by category for the three and six months ended June 30, 2008, as compared to the same periods of the prior year. Core noninterest income declined approximately \$67,000, or 0.1%, and increased \$5.2 million, or 5.3%, for the three and six months ended June 30, 2008, respectively, as compared to the same periods of the prior year.

	Three Months Ended		Increase (decrease)		Six Months Ended		Increase (decrease)	
	June 30, 2008	2007	\$	%	June 30, 2008	2007	\$	%
	(Dollars in thousands)							
Service charges on deposit accounts	\$ 19,259	\$ 18,694	\$ 565	3.0 %	\$ 38,487	\$ 36,373	\$ 2,114	5.8 %
Electronic banking	5,275	4,648	627	13.5 %	10,279	9,049	1,230	13.6 %
Other retail banking fees	2,540	3,255	(715)	(22.0)%	5,088	6,867	(1,779)	(25.9)%
Retail banking fees	27,074	26,597	477	1.8 %	53,854	52,289	1,565	3.0 %
Mortgage banking origination and sales	7,953	3,660	4,293	117.3 %	14,713	6,847	7,866	114.9 %
Financial planning services	5,061	4,283	778	18.2 %	9,873	8,105	1,768	21.8 %
Mortgage warehouse fees	1,251	6,332	(5,081)	(80.2)%	2,246	13,287	(11,041)	(83.1)%
Bank-owned life insurance	5,169	5,002	167	3.3 %	10,289	9,957	332	3.3 %
Other income	6,190	6,891	(701)	(10.2)%	13,395	8,674	4,721	54.4 %
Core noninterest income	52,698	52,765	(67)	(0.1)%	104,370	99,159	5,211	5.3 %
Securities and derivatives gains, net	3,025	1,116	1,909	171.1 %	9,100	2,097	7,003	334.0 %
Securities restructuring charges						(36,006)	36,006	100.0 %
Gain on sale of mortgage loans						3,850	(3,850)	(100.0)%
Gain on sale of merchant services		4,900	(4,900)	(100.0)%		4,900	(4,900)	(100.0)%
Total noninterest income	\$ 55,723	\$ 58,781	\$ (3,058)	(5.2)%	\$ 113,470	\$ 74,000	\$ 39,470	53.3 %

Service charges on deposit accounts is comprised of nonsufficient funds fees and service charges on consumer and commercial deposit accounts. Noninterest income from service charges on deposit accounts increased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year. Noninterest income from nonsufficient funds fees is the largest component of these increases and is primarily due to an increase in the number of customer accounts.

Electronic banking includes fees from Colonial's ATM network, business and personal check card services and internet banking. Noninterest income from electronic banking services increased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily because of an increase in the number of Colonial customer accounts as well as the Company's focused efforts to increase customer check card usage and ATM network fees.

Other retail banking fees decreased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to lower official check commissions and the Company's sale of its merchant services contracts in April 2007. The decline in official check commissions was primarily due to a decrease in rate. Merchant services revenue declined due to the Company's sale of contracts and the subsequent

**Table of Contents**

agent bank agreement with a third party service provider of merchant services. The outsourced relationship lowers Colonial's inherent risk of providing merchant services while enabling the Company to continue to offer those services to its customer base. The referral fees for new contracts are less than the previous fee income, but the Company's expenses and risks are also reduced. As part of the sale, Colonial recognized a \$4.9 million gain as noted separately in the table above.

Mortgage banking origination and sales revenue is derived from mortgage loans originated and subsequently sold in the secondary market. The Company does not retain any servicing rights related to these loans. Mortgage banking sales volume increased 37% and 39% for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to a team of experienced prime mortgage originators hired in late 2007. In addition, profit margins improved due to a shift to higher margin FHA and VA products from other products and enhanced control over pricing and delivery.

Financial planning services include discount brokerage, investment sales, asset management, trust services and insurance sales including term, universal, whole life and long-term care. Financial planning services revenue increased for the three months ended June 30, 2008, as compared to the same period of the prior year, primarily due to fixed annuity sales and securities commissions, partially offset by a decline in variable annuity sales and trust revenues. Financial planning services revenue increased for the six months ended June 30, 2008, as compared to the same period of the prior year, primarily due to fixed and variable annuity sales, partially offset by a decline in security commissions and trust revenue.

Mortgage warehouse fees are comprised of three revenue streams: servicing and other fees associated with interests in mortgage warehouse assets sold to third-party commercial paper conduits, custodial fees associated with mortgage document services for mortgage warehouse customers and syndication fees paid to the Company as agent or participant in mortgage warehouse syndicated loans. The decrease in mortgage warehouse fees for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, was primarily the result of lower servicing and other fees due to the discontinuation of sales of assets to third-party commercial paper conduits in early January 2008.

Income from bank-owned life insurance increased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to the increased value of the policies.

Other income reflects revenues from joint ventures, letter of credit fees, condo association coupon fees, gains on the sales of bank premises and several other small items. The decline for the three months ended June 30, 2008, as compared to the same period of the prior year, was primarily the result of a \$3.5 million decline in revenue from joint ventures and a \$1.3 million increase in the unfavorable fair value adjustment on retail mortgage forward sale commitments, partially offset by an increase in revenue of \$4.3 million from gains related to the sale of bank premises and equipment and the continued amortization of gains associated with the 2007 sale-leaseback of 56 bank locations. The increase for the six months ended June 30, 2008, as compared to the same period of the prior year, was primarily the result of an increase in revenue of \$5.9 million from gains related to the sale of bank premises, a \$2.1 million gain on the sale of Visa, Inc. stock from an initial public offering and a \$1.5 million increase in servicing income partially offset by a decline of \$3.9 million in joint venture revenue.

The Company's decision to buy and sell securities is based on its management of interest rate risk and projected liquidity and funding needs. During 2008, the Company recorded gains of \$6.1 million in the first quarter from the sale of approximately \$217 million in securities and a \$3.0 million gain in the second quarter from the early termination of a \$250 million resell agreement. In the first quarter of 2007, the Company recorded gains of \$981,000 on the sale of \$163 million in securities and recognized an impairment loss of \$36.0 million as the Company declared its intent to restructure its securities portfolio by selling approximately \$1.2 billion in available for sale securities. The securities were sold in April 2007. Also in the second quarter of 2007, the Company recorded gains of \$1.1 million from the sale of additional available for sale debt securities and 15,570 shares of equity securities.

**Table of Contents**

The Company sold approximately \$490 million of residential real estate loans in March 2007 and recognized a \$3.9 million gain.

**Noninterest Expense**

The following table shows the dollar and percentage change in noninterest expense by category for the three and six months ended June 30, 2008, as compared to the same periods of the prior year. Core noninterest expense increased \$22.2 million, or 16.1%, and \$49.7 million, or 18.6%, for the three and six months ended June 30, 2008, respectively, as compared to the same periods of the prior year. Annualized core noninterest expense to average assets was 2.36% and 2.32% for the three and six months ended June 30, 2008, respectively, as compared to 2.38% and 2.32% for the three and six months ended June 30, 2007, respectively.

	Three Months Ended		Increase		Six Months Ended		Increase	
	June 30,		(decrease)		June 30,		(decrease)	
	2008	2007	\$	%	2008	2007	\$	%
	(Dollars in thousands)							
Salaries and employee benefits	\$ 74,761	\$ 70,256	\$ 4,505	6.4 %	\$ 148,428	\$ 139,810	\$ 8,618	6.2 %
Occupancy expense of bank premises, net	24,064	18,722	5,342	28.5 %	47,119	37,227	9,892	26.6 %
Furniture and equipment expenses	15,134	13,350	1,784	13.4 %	29,837	26,472	3,365	12.7 %
Professional services	7,807	4,628	3,179	68.7 %	13,445	8,728	4,717	54.0 %
FDIC insurance and other regulatory fees	4,414	1,232	3,182	258.3 %	8,976	2,445	6,531	267.1 %
Amortization of intangible assets	4,142	3,201	941	29.4 %	8,305	6,252	2,053	32.8 %
Electronic banking and other retail banking expenses	4,136	5,507	(1,371)	(24.9)%	8,293	9,719	(1,426)	(14.7)%
Loan and other real estate related costs	4,486	898	3,588	399.6 %	7,135	1,236	5,899	477.3 %
Communications	2,863	2,900	(37)	(1.3)%	5,682	5,891	(209)	(3.5)%
Advertising	2,384	3,683	(1,299)	(35.3)%	4,987	5,898	(911)	(15.4)%
Postage and courier	2,270	2,692	(422)	(15.7)%	4,892	5,331	(439)	(8.2)%
Loss on equity investments	1,720	670	1,050	156.7 %	4,467	925	3,542	382.9 %
Travel	1,522	1,950	(428)	(21.9)%	2,961	3,689	(728)	(19.7)%
Other expenses	9,803	7,647	2,156	28.2 %	22,789	14,004	8,785	62.7 %
Core noninterest expense	159,506	137,336	22,170	16.1 %	317,316	267,627	49,689	18.6 %
Severance expense	550	520	30	5.8 %	786	3,545	(2,759)	(77.8)%
Merger related expense		1,116	(1,116)	(100.0)%		1,545	(1,545)	(100.0)%
Net losses related to the early extinguishment of debt	4,111	2,512	1,599	63.7 %	10,043	6,908	3,135	45.4 %
Total noninterest expense	\$ 164,167	\$ 141,484	\$ 22,683	16.0 %	\$ 328,145	\$ 279,625	\$ 48,520	17.4 %

Salaries and benefits increased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year. The change was primarily due to increases in commissions resulting from higher mortgage banking and financial planning services production as well as an increase in the Company's number of full-time equivalent employees. The total number of full-time equivalent employees increased in both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to the Company's two acquisitions in the prior year, but was partially offset by reductions in workforce in 2007 and 2008.

**Table of Contents**

The increases in occupancy and furniture and equipment expenses for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, were primarily the result of the acquisitions of Commercial Bankshares, Inc. and Citrus & Chemical Bancorporation, information technology costs, charges related to abandoned leases and increased lease expense resulting from the sale-leaseback of 56 properties in 2007. The increased occupancy expense from the sale-leaseback is more than offset by the amortization of deferred gains on the sales, which are included in noninterest income.

Professional services increased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to increased use of outsourced technology related services, higher legal fees associated with lending activities and higher accounting fees.

FDIC insurance and other regulatory fees were higher for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, due to increases in deposits and assets on which they are based, as well as the depletion of Colonial Bank's assessment credits in 2007 which reduced prior years' fees.

Amortization of intangible assets increased for the three and six months ended June 30, 2008, as compared to the same periods of the prior year, due to additional core deposit intangible assets recorded for the Commercial Bankshares, Inc. and Citrus & Chemical Bancorporation, Inc. acquisitions in 2007.

Electronic banking and other retail banking expenses are comprised of electronic banking costs, customer supplies, processing service charges, fraud and operating losses and other expenses. Total electronic banking and other retail banking expenses decreased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year. The decrease for both the three and six months ended June 30, 2008 was primarily due to an \$804,000 and \$858,000 decrease in fraud losses and a \$710,000 and \$1.2 million decrease in consulting expenses related to discontinued revenue enhancements, respectively.

The increase in loan and other related costs for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, were driven by higher expenses related to other real estate.

Advertising expenses decreased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, primarily due to decreased use of newspaper and radio ads for deposit gathering initiatives.

Postage and courier expenses decreased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, due to increased customer usage of e-statements and management's focused efforts to control these costs.

Loss on equity investments increased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, due primarily to impairment recognized on certain equity investments.

Travel expenses decreased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year, due to management's increased focus on reducing travel and entertainment expenses.

Other expenses increased for both the three and six months ended June 30, 2008, as compared to the same periods of the prior year. For the three months ended June 30, 2008, the increase was primarily due to a \$2.4 million increase in subservicing fees associated with an increase in average balances of mortgage warehouse assets, increased expenses related to real estate joint ventures of \$936,000 and numerous operational expenses that have increased in conjunction with an increase in the number of branches. Also included in other expenses for the three months ended June 30, 2008 is a net fair value gain between the lower of cost or fair value on mortgage loans held for sale and the related call options sold totaling \$730,000.



**Table of Contents**

For the six months ended June 30, 2008, the increase in other expenses was primarily due to a \$5.0 million increase in subservicing fees associated with the increased balances of mortgage warehouse assets, increased expenses related to real estate joint ventures of \$1.1 million and numerous operational expenses that have increased in conjunction with an increase in the number of branches. Also included in the six months ended June 30, 2008 is a net fair value loss between the lower of cost or fair value on mortgage loans held for sale and the related call options sold totaling \$1.6 million.

Severance expense relates primarily to the reduction in force efforts in 2007. This expense decreased significantly for the first six months of 2008.

Merger related expenses were incurred to integrate Commercial Bankshares, Inc. and Citrus & Chemical Bancorporation, Inc. in 2007. The costs consisted of travel, training, marketing, retention bonuses and incremental charges related to the integration of the acquired banks.

During the first quarter of 2008, the Company prepaid a \$100 million Federal Home Loan Bank (FHLB) advance at a rate of 4.68% and incurred a \$5.9 million net loss related to the early extinguishment. During the second quarter of 2008, a \$4.1 million loss was incurred on the early termination of \$105 million in FHLB advances with an average interest rate of 4.66% and the call of \$43 million in brokered time deposits with an average interest rate of 4.80%. During the first quarter of 2007, the Company redeemed \$70 million of trust preferred securities at a rate of 8.92% and incurred a \$4.4 million net loss related to the early extinguishment. During the second quarter of 2007, the Company redeemed an additional \$100 million of trust preferred securities at a rate of 8.32% and incurred a \$2.5 million net loss related to the early extinguishment.

**Provision for Income Taxes**

BancGroup's provision for income taxes was based on an approximate 2.0% and 33.3% estimated effective tax rates for the six months ended June 30, 2008 and 2007, respectively. The effective tax rate was lower in the first six months of 2008, as compared to the same period of the prior year, primarily due to increases in permanent exclusions and tax credits as a percentage of pretax income. The provisions for income taxes for the six months ended June 30, 2008 and 2007 was \$0.3 million and \$51.3 million, respectively.

**Table of Contents****REVIEW OF STATEMENT OF CONDITION****Financial Condition**

Changes in selected components of the Company's balance sheet from December 31, 2007 to June 30, 2008 are as follows:

	June 30, 2008	December 31, 2007	Increase (Decrease)	
			\$	%
(Dollars in thousands)				
Securities purchased under agreements to resell	\$ 2,185,174	\$ 2,049,664	\$ 135,510	6.6%
Securities	3,453,859	3,682,510	(228,651)	(6.2)
Loans held for sale	1,984,723	1,544,222	440,501	28.5
Loans, net of unearned income	15,468,832	15,923,178	(454,346)	(2.9)
Goodwill	1,008,298	1,008,168	130	0.0
Other real estate owned	113,470	15,760	97,710	620.0
Total assets	26,031,291	25,975,989	55,302	0.2
Non-time deposits	8,964,845	9,771,573	(806,728)	(8.3)
Total deposits	18,349,165	18,544,267	(195,102)	(1.1)
Short-term borrowings	660,724	568,721	92,003	16.2
Long-term debt	4,037,741	4,023,836	13,905	0.4
Minority interest/REIT preferred securities	293,058	293,058		
Shareholders' equity	2,421,992	2,273,571	148,421	6.5

**Securities**

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

	Carrying Value at June 30, 2008	Carrying Value at December 31, 2007
(In thousands)		
<b>Securities available for sale:</b>		
Mortgage-backed securities and other pass-through securities of GSE's	\$ 698,055	\$ 655,636
Collateralized mortgage obligations	2,224,933	2,404,914
Obligations of state and political subdivisions	352,406	371,930
Corporate notes		6,819
Federal Reserve and FHLB stock and other	177,292	241,983
<b>Total securities available for sale</b>	<b>3,452,686</b>	<b>3,681,282</b>
<b>Held to maturity securities:</b>		
U.S. Treasury securities and obligations of GSE's	500	500
Mortgage-backed securities of GSE's	432	486
Collateralized mortgage obligations	8	9
Obligations of state and political subdivisions	233	233
<b>Total held to maturity securities</b>	<b>1,173</b>	<b>1,228</b>
<b>Total securities</b>	<b>\$ 3,453,859</b>	<b>\$ 3,682,510</b>



**Table of Contents****Securities by Credit Rating at June 30, 2008**

	Government / GSE Obligations	Standard & Poor's or Equivalent Designation			Other	Total
		AAA	A-to AA+	Unrated		
(In thousands)						
U.S. Treasury securities and obligations of GSE's	\$ 500	\$	\$	\$	\$	\$ 500
Mortgage-backed and other pass-through securities of GSE's	698,487					698,487
Collateralized mortgage obligations	745,604	1,479,336				2,224,940
Obligations of state and political subdivisions		158,017	191,379	1,166	2,078	352,640
Federal Reserve and FHLB stock and other					177,292	177,292
Total securities	\$ 1,444,591	\$ 1,637,353	\$ 191,379	\$ 1,166	\$ 179,370	\$ 3,453,859

**Securities by Credit Rating at December 31, 2007**

	Government / GSE Obligations	Standard & Poor's or Equivalent Designation			Other	Total
		AAA	A-to AA+	Unrated		
(In thousands)						
U.S. Treasury securities and obligations of GSE's	\$ 500	\$	\$	\$	\$	\$ 500
Mortgage-backed and other pass-through securities of GSE's	656,122					656,122
Collateralized mortgage obligations	703,876	1,701,047				2,404,923
Obligations of state and political subdivisions		368,048	2,321	1,794		372,163
Federal Reserve and FHLB stock and other			4,965		243,837	248,802
Total securities	\$ 1,360,498	\$ 2,069,095	\$ 7,286	\$ 1,794	\$ 243,837	\$ 3,682,510

During the second quarter of 2008, the Company did not sell any securities and purchased approximately \$128 million in new securities, excluding transactions in Federal Home Loan Bank of Atlanta (FHLB) stock. In April 2008, the Company recorded a gain of \$3.0 million from the early termination of a \$250 million resell agreement. In connection with its conversion to a state chartered bank, during the second quarter of 2008, Colonial Bank surrendered approximately 1.2 million shares of Federal Reserve Bank Stock at a par value of \$61.3 million plus accrued dividends.

During the first quarter of 2008, the Company sold approximately \$217 million in securities and purchased approximately \$219 million in new securities, excluding transactions in FHLB stock.

**Table of Contents****Mortgage Warehouse Assets**

Colonial had a facility in which it sold certain mortgage warehouse loans and short-term participations reported as loans held for sale to a wholly-owned special purpose entity which then sold interests in those assets to third-party commercial paper conduits (conduits). In January 2008, the Company's strong liquidity position enabled Colonial to reduce mortgage warehouse assets sold to \$0, at which point the facility was terminated by its terms. The assets that had been sold to the conduits had the same high quality credit characteristics as those on Colonial's balance sheet.

A summary of the major components of the mortgage warehouse division's assets is shown in the table below:

	June 30, 2008	December 31, 2007
	(In thousands)	
Securities purchased under agreements to resell	\$ 1,935,174	\$ 1,549,664
Loans held for sale	1,904,174	1,484,502
Mortgage warehouse loans	580,555	290,603
Total mortgage warehouse assets on balance sheet	4,419,903	3,324,769
Interests sold		
Loans held for sale		769,221
Mortgage warehouse loans		230,779
Total mortgage warehouse assets under management	\$ 4,419,903	\$ 4,324,769

**Loans Held for Sale**

Loans held for sale is comprised of three elements: short-term participations in mortgage loans, retail mortgages and other loans held for sale. Total loans held for sale at June 30, 2008 increased \$441 million, or 28.5%, from December 31, 2007, primarily due to an increase in participations purchased by the mortgage warehouse division driven by customer demand and an increase in VA and FHA retail mortgages originated by Colonial. Loans held for sale fluctuate as demand for residential mortgages changes and customer demands change. A summary of the elements that make up loans held for sale is shown in the table below:

	June 30, 2008	December 31, 2007
	(In thousands)	
Short-term participations in mortgage loans held for sale	\$ 1,904,174	\$ 1,484,502
Retail mortgage loans held for sale	74,927	59,720
Other loans held for sale	5,622	
Total loans held for sale	\$ 1,984,723	\$ 1,544,222

**Loans**

As real estate markets in the U.S. have deteriorated over recent quarters, the demand for loan products has declined. The impact has been most noticeable in the residential construction market. An impact of the economic slowdown to Colonial is decreased demand for loans from customers who meet the Company's underwriting criteria. Total loans, net of unearned income, excluding the mortgage warehouse division, decreased \$744 million, or 4.8%, from December 31, 2007 to June 30, 2008. Loans in the mortgage warehouse division increased \$290.0 million from December 31, 2007. Mortgage warehouse loans increased because Colonial stopped selling interests in mortgage warehouse loans to third-party commercial paper conduits and terminated the off balance sheet facility in January 2008. In addition, as the overall market demand for mortgages has become more concentrated, the Company's mortgage warehouse customers have increased the usage of their lines as a result of their increased market share.



**Table of Contents****Gross Loan Portfolio**

The following table shows the Company's loans by type at June 30, 2008 and December 31, 2007:

	June 30, 2008	December 31, 2007
	(In thousands)	
Commercial, financial and agricultural	<b>\$ 1,660,417</b>	\$ 1,506,986
Commercial real estate	<b>4,989,456</b>	5,012,773
Real estate construction	<b>5,784,204</b>	6,296,262
Residential real estate	<b>2,608,066</b>	2,673,823
Consumer and other	<b>443,810</b>	452,642
Total loans	<b>15,485,953</b>	15,942,486
Less: unearned income	<b>(17,121)</b>	(19,308)
Total loans, net of unearned income	<b>\$ 15,468,832</b>	\$ 15,923,178

Loans classified as commercial, financial and agricultural consist of secured and unsecured credit lines and amortizing loans for various industrial, agricultural, commercial, financial, retail or service businesses, as well as mortgage warehouse lines of credit.

Commercial real estate loans are collateralized by real estate held for investment and business purposes. Included in commercial real estate are loans categorized as owner-occupied, which totaled \$1.7 billion, or 11.2% of the total loan portfolio, at June 30, 2008.

Real estate construction loans are made to individuals, companies or developers for use in the purchase or construction of commercial properties such as single and multi-family residential and non-residential real estate. These loans are repaid by the cash flows generated through the operation, sale or refinancing of the underlying commercial property.

Residential real estate loans consist primarily of adjustable and fixed rate first mortgages on single-family, owner-occupied properties.

Consumer and other loans include loans to individuals or businesses for various purposes that may be unsecured or secured with assorted types of collateral such as cars, trucks, boats, stocks and depository accounts.

## **Table of Contents**

Types of loans in this category include loans for investment purposes, vehicle purchases, purchases of personal property, personal expense loans and overdrafts of deposit accounts. These loans are made to individuals and businesses such as financial institutions, municipalities and not-for-profit organizations.

### **Other Earning Assets**

Other earning assets is comprised of interest bearing deposits in banks, federal funds sold and securities purchased under agreements to resell. Total other earning assets increased \$146 million, or 7%, from December 31, 2007 to June 30, 2008, primarily due to an increase in interest bearing deposits in banks and securities purchased under agreements to resell partially offset by a decrease in federal funds sold.

### **Goodwill**

BancGroup records goodwill in an amount equal to the excess of the cost of an acquisition over the fair value of the net assets acquired. During the first six months of 2008, BancGroup continued to finalize the purchase accounting for acquisitions that closed during 2007, thereby resulting in a \$3 million reduction in goodwill in the first quarter and a \$3 million increase in the second quarter. BancGroup tests goodwill for impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. In light of the challenging interest rate and credit environments that have persisted since late 2007, and the fact that the Company's stock has been trading below book value per share, interim impairment testing was performed at December 31, 2007, March 31, 2008 and June 30, 2008. The estimated fair values of the Company's reporting units were based on discounted cash flow models derived from internal earnings forecasts. Based on current results and expectations, BancGroup has determined that the fair values of its reporting units continue to exceed their carrying values. Therefore, management determined that no goodwill impairment charge was required as of June 30, 2008.

Due to the ongoing uncertainty in market conditions, which may continue to negatively impact the performance of BancGroup's reporting units, management will continue to monitor and evaluate the carrying value of goodwill, particularly with respect to the Florida reporting units. Earnings forecasts relating to the Company's reporting units have generally declined over the past two quarters. If market and economic conditions or business performance deteriorate further, this could increase the likelihood of the Company recording an impairment charge to the extent that the book equity value, including goodwill, exceeds the estimated fair value of the reporting unit.

### **Other Real Estate Owned**

Total other real estate owned increased \$97.7 million from December 31, 2007 to June 30, 2008. The increase was driven by the Company's aggressive management of its problem loans in response to deteriorating credit quality. A substantial portion of the outstanding balance relates to properties in prime, waterfront locations in Florida and coastal Alabama.

### **Deposits**

Total deposits decreased \$195 million, or 1%, from December 31, 2007 to June 30, 2008. The decrease was driven by transaction accounts and brokered time deposits which decreased \$807 million and \$110 million, or 8.3% and 7.6%, respectively, over that same time period. This decrease was partially offset by an increase in time deposits of \$722 million, or 9.9%. Refer to the *Liquidity and Funding* section of Management's Discussion and Analysis for further information.



---

**Table of Contents****Wholesale Borrowings**

Wholesale borrowings are comprised of short-term borrowings and long-term debt. Short-term borrowings consist of repurchase agreements and federal funds purchased. Total short-term borrowings increased \$92 million, or 16%, from December 31, 2007 to June 30, 2008. Repurchase agreements decreased \$43 million, or 8%, and federal funds purchased increased \$135 million from December 31, 2007 to June 30, 2008. Long-term debt consists of FHLB advances, subordinated debt, junior subordinated debt, and capital lease obligations. Total long-term debt increased \$14 million, or 0.35%, from December 31, 2007 to June 30, 2008. During the period from December 31, 2007 to June 30, 2008, the Company issued \$250 million in subordinated debt, which qualifies as Tier 2 regulatory capital; paid off \$214 million in FHLB borrowings; and paid off \$7.7 million of variable rate subordinated debt and \$10.2 million of fixed rate subordinated debt. Refer to Note 11, *Long-Term Debt*, for additional information.

**RISK MANAGEMENT**

In January 2008, BancGroup created a Risk Committee composed of independent directors to monitor all of Colonial's risk factors.

**Credit Risk Management**

Colonial has some measure of credit risk in most of its primary banking activities, but the majority of this risk is associated with lending. Colonial's Credit Risk Management philosophy has historically been, and continues to be, focused on establishing and administering policies and procedures such that Colonial's credit quality has outperformed Colonial's peers in most economic environments. Consistent with this philosophy, Colonial has maintained conservative underwriting and credit product standards and has generally avoided nontraditional credit products. The Company's credit risk management process is centered on comprehensive credit and underwriting policies and procedures, a strong and effective loan approval process, continual audit and review functions and experienced credit professionals at the regional, business-line and BancGroup levels. In addition, Colonial has a credit risk reporting and analysis group which continually evaluates changes in credit risk, monitors large concentrations and exposures of all types and locations and implements Colonial Bank's allowance methodology. Colonial also has a special assets/collections group which is charged with minimizing losses, maximizing recoveries and implementing strategies to reduce problem asset levels. In addition, the internal auditors and regulatory examiners review and perform detailed tests of the Company's credit risk management activities, such as credit underwriting, loan administration and the allowance process. The overall goals of Colonial's credit risk management activities include providing a sound basis for new credit extensions and early recognition of problems/risks so that Colonial can maintain a high quality loan portfolio and achieve long-term earnings growth.

In addition to lending, credit risk is present in Colonial's securities portfolio, derivative instruments and certain deposit activities. The Company's treasury and deposit departments have credit risk management processes in place in order to manage credit risk in these activities.

**Commercial Real Estate and Real Estate Construction Loan Categories**

A large portion of BancGroup's loans are secured by real estate, with commercial real estate and construction loans representing 32.2% and 37.4% of total loans as of June 30, 2008, respectively. BancGroup's commercial real estate and construction loans are spread geographically throughout Alabama, Florida and other areas including metropolitan Atlanta, Dallas, Reno and Las Vegas with no more than 12.57% of total commercial real estate and construction loans in any one metropolitan statistical area (MSA). The Alabama economy generally experiences a slow but steady rate of growth, while BancGroup's markets in Florida, Georgia, Nevada and Texas have historically experienced higher rates of growth. Currently, Florida, metro Atlanta and Nevada are experiencing a slow-down in real estate markets due to over supply of houses as well as less demand for real estate. The collateral held in the commercial real estate and construction portfolios consists of various property types such as retail properties, 1-4 family residential developments and lots, office buildings, land held for future

**Table of Contents**

development or construction, residential homes under construction, multi-family housing, condominium properties, warehouses, lodging and health service facilities. The relatively small average loan size and the application of conservative underwriting guidelines further reduce risk. Colonial focuses its commercial real estate and construction lending efforts on high quality properties owned and/or developed by experienced customers with whom BancGroup has established relationships. In addition to the subject properties, substantially all construction and commercial real estate loans have personal guarantees of the principals involved. The owner-occupied commercial real estate portfolio represented 34.6% of the total commercial real estate portfolio outstanding at June 30, 2008. Owner-occupied real estate is primarily dependent on cash flows from operating businesses rather than on the sale or rental of the property; therefore, these loans generally carry less risk than other commercial real estate loans.

Management believes that Colonial's existing diversity of commercial real estate and construction loans reduces BancGroup's risk exposure. The current distribution remains diverse in location, size and collateral function. This diversification, in addition to Colonial's emphasis on quality underwriting, serves to reduce the risk of losses. The following charts reflect the geographic diversity and property type distribution of total construction and commercial real estate loans at June 30, 2008:

	Construction	% of Total (Dollars in thousands)	Commercial Real Estate	% of Total
<b>Average Loan Size</b>	\$ 1,081		\$ 718	
<b>Weighted Average Loan to Value</b>	71.2%		63.9%	
<b>Geographic Diversity (by property location)(1)</b>				
Florida	\$ 2,716,378	47.0%	\$ 3,150,735	63.1%
Alabama	576,500	10.0%	586,614	11.8%
Georgia	613,942	10.6%	309,145	6.2%
Texas	927,236	16.0%	388,717	7.8%
Nevada	512,258	8.9%	190,315	3.8%
Other	437,890	7.5%	363,930	7.3%
Total	\$ 5,784,204	100.0%	\$ 4,989,456	100.0%

	Property Type Distribution %			Property Type Distribution %	
	Construction Portfolio	Total Portfolio		Commercial Real Estate Portfolio	Total Portfolio
<b>Residential Construction</b>			Office	22.7%	7.3%
Residential development and lots	26.5%	9.9%	Retail	22.0%	7.1%
Residential home construction	11.9%	4.5%	Warehouse	14.4%	4.6%
Residential land	7.3%	2.7%	Multi-Family	8.7%	2.8%
Condominium	5.2%	2.0%	Healthcare	8.4%	2.7%
<b>Total Residential Construction</b>	50.9%	19.1%	Lodging	5.1%	1.6%
<b>Commercial Construction</b>			Church or School	3.8%	1.2%
Commercial land	16.6%	6.2%	Industrial	3.0%	1.0%
Commercial development and lots	10.4%	3.9%	Farm	2.4%	0.8%
Retail	6.8%	2.5%	Other(2)	9.5%	3.1%
Multi-Family	3.6%	1.4%	<b>Total Commercial Real Estate</b>	100.0%	32.2%
Office	3.5%	1.3%			
Other(2)	8.2%	3.0%			

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

<b>Total Commercial Construction</b>	49.1%	18.3%
<b>Total Construction</b>	100.0%	37.4%

- (1) No more than 12.57% of construction and commercial real estate loans are in any one MSA.
- (2) Other includes all loans in categories smaller than the lowest percentages shown above.

**Table of Contents****Selected Characteristics of the 75 Largest Construction and Commercial Real Estate Loans**

	<b>Construction</b>	<b>Commercial Real Estate</b>
<b>75 Largest Loans Total (in thousands)</b>	\$ 1,307,884	\$ 938,752
% of 75 largest loans to category total	22.6%	18.8%
Average Loan to Value Ratio (75 largest loans)	70.9%	68.5%
Average Debt Coverage Ratio (75 largest loans)	N/A	1.53

**Residential Construction Loan Category**

Residential construction represents approximately half of the Company's total construction portfolio and consists of residential development and lots, residential home construction, residential land and condominiums. The loans are generally short-term, have the personal guarantees of the borrowers and are underwritten such that each borrower has substantial equity in the project. The weighted average loan to value of the residential construction portfolio was 73.6% at June 30, 2008.

The majority of the Company's nonperforming assets and net charge-offs during recent quarters relate to residential construction loans. The lack of real estate sales has caused liquidity issues for some of the Company's borrowers which have resulted in higher than historical levels of nonperforming loans and losses in this portfolio.

The following table and chart show the components of residential construction loans, excluding nonperforming loans of approximately \$184.7 million, at June 30, 2008:

**Residential Construction Loans**

	<b>Total Outstanding</b>		<b>Residential Development</b>	<b>Builder Lot</b>				<b>Residential Speculative</b>	<b>Land</b>	<b>Condominiums</b>	<b>National Builders</b>
	Amount	%		Inventory	Owned Lots	Presold	(Dollars in millions)				
Florida	\$ 1,368	49%	\$ 529	\$ 62	\$ 82	\$ 77	\$ 204	\$ 199	\$ 215	\$	
Texas	495	18	262	38	5	14	57	73	17	29	
Georgia	354	13	171	23	1	37	76	26	20		
Alabama	318	11	95	36	27	35	99	19	7		
Nevada	154	6	60	1	2	22	29	40			
Other	77	3	13	1	1	2	5	40	15		
<b>Total</b>	<b>\$ 2,766</b>	<b>100%</b>	<b>\$ 1,130</b>	<b>\$ 161</b>	<b>\$ 118</b>	<b>\$ 187</b>	<b>\$ 470</b>	<b>\$ 397</b>	<b>\$ 274</b>	<b>\$ 29</b>	

**Residential Construction Loans**

**Table of Contents*****Other Loan Categories***

The risks associated with loans classified as commercial, financial and agricultural are generally related to the earnings capacity of, and the cash flows generated from, the specific business activities of the borrowers.

BancGroup has a history of successful residential real estate lending, and the asset quality ratios for residential real estate loans remain favorable. The Company has conservative underwriting guidelines and has not offered any products targeting sub-prime borrowers and does not offer higher risk mortgage products such as option ARMs, pick a payment loans and low or no documentation loans. The weighted average loan to value of this portfolio was 71.4% at June 30, 2008.

Regarding consumer and other loans, the principal source of repayment is the earning capacity of the individual borrower and, on collateralized loans, the collateral serves as a secondary source of repayment.

***Allowance for Loan Losses***

Management's ongoing evaluation of the adequacy of the allowance for loan losses considers both impaired and unimpaired loans and takes into consideration Colonial's past loan loss experience, known and inherent risks in the portfolio, existing adverse situations that may affect the borrowers' ability to repay, estimated value of any underlying collateral, an analysis of existing guarantees and an analysis of current economic conditions.

Colonial, through its lending and credit functions, continuously reviews its loan portfolio for credit risk. Colonial employs an independent credit review area that reviews the lending and credit functions to validate that credit risks are appropriately identified. The Company remains committed to the early recognition of problem loans and to ensuring an adequate level of allowance to cover inherent losses. Using information derived from the credit risk identification process, the Company's credit risk management area analyzes and validates the Company's allowance for loan losses calculations. The analysis includes four basic components: general allowances for loan pools, specific allowances for individual loans, allowances based on identified economic conditions and other risk factors and the overall allowance level (which gives rise to the unallocated component of the allowance).

Management reviews the methodology, calculations and results and ensures that the calculations are appropriate and that all material risk elements have been assessed in order to determine the appropriate level of allowance for the inherent losses in the loan portfolio at each quarter end. Past due balances, nonaccrual balances, and potential problem loan balances are not absolute indicators of the losses inherent in the loan portfolio, but are considered in the overall evaluation of the adequacy of the allowance for loan losses. In addition, the allowance for loan losses methodology is discussed with, and reviewed by, the Risk Committee of the Board of Directors on a quarterly basis.

The following table summarizes the Company's loan loss experience for the periods ended June 30, 2008 and 2007:

	<b>Six Months Ended</b>	
	<b>June 30, 2008</b>	<b>June 30, 2007</b>
	<b>(In thousands)</b>	
Balance, January 1	<b>\$ 238,845</b>	\$ 174,850
Addition due to acquisition		7,147
Provision charged to income	<b>114,543</b>	8,355
Reduction due to sale of mortgage loans originally held for investment		(2,303)
Loans charged off	<b>(109,191)</b>	(12,776)
Recoveries	<b>2,812</b>	3,001
<b>Balance, June 30</b>	<b>\$ 247,009</b>	\$ 178,274

**Table of Contents****Analysis of Net Charge-Offs**

	Three Months Ended		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
(Dollars in thousands)				
<b>Charge-offs:</b>				
Commercial, financial and agricultural	\$ 2,189	\$ 1,381	\$ 4,451	\$ 2,402
Commercial real estate	6,931	632	7,925	868
Real estate construction	58,956	5,945	86,954	6,976
Residential real estate	4,580	338	6,040	551
Consumer and other	1,445	938	3,821	1,979
<b>Total charge-offs</b>	<b>74,101</b>	<b>9,234</b>	<b>109,191</b>	<b>12,776</b>
<b>Recoveries:</b>				
Commercial, financial, agricultural	593	893	863	1,378
Commercial real estate	126	15	207	37
Real estate construction	91	2	368	41
Residential real estate	93	137	307	370
Consumer and other	412	607	1,067	1,175
<b>Total recoveries</b>	<b>1,315</b>	<b>1,654</b>	<b>2,812</b>	<b>3,001</b>
<b>Net charge-offs:</b>				
Commercial, financial, agricultural	1,596	488	3,588	1,024
Commercial real estate	6,805	617	7,718	831
Real estate construction	58,865	5,943	86,586	6,935
Residential real estate	4,487	201	5,733	181
Consumer and other	1,033	331	2,754	804
<b>Total net charge-offs</b>	<b>\$ 72,786</b>	<b>\$ 7,580</b>	<b>\$ 106,379</b>	<b>\$ 9,775</b>
<b>Percent of net charge-offs to average loan category (annualized basis):</b>				
Commercial, financial, agricultural	0.39%	0.14%	0.44%	0.15%
Commercial real estate	0.54%	0.06%	0.31%	0.04%
Real estate construction	3.91%	0.37%	2.84%	0.22%
Residential real estate	0.68%	0.03%	0.44%	0.01%
Consumer and other	0.96%	0.27%	1.18%	0.33%
<b>Total</b>	<b>1.85%</b>	<b>0.20%</b>	<b>1.35%</b>	<b>0.13%</b>

**Nonperforming Assets and Potential Problem Loans**

Management maintains an aggressive nonaccrual and problem loan identification philosophy. Through the ongoing monitoring and review of all pools of risk in the loan portfolio, this philosophy aids in the quick identification of problem loans and the minimization of the risk of loss.

Nonperforming assets consist of loans on nonaccrual status, renegotiated loans, other real estate owned, repossessions and loans held for sale on nonaccrual status. When management determines that a loan no longer meets the criteria for a performing loan and collection of interest appears doubtful, the loan is placed on nonaccrual status. Loans are generally placed on nonaccrual if full collection of principal and interest becomes unlikely (even if all payments are current) or if the loan is delinquent in principal or interest payments for 90 days or more, unless the loan is well secured and in the process of collection. BancGroup's policy is to charge-off consumer installment loans 120 days past due unless they are in the process of foreclosure and are adequately collateralized. Management closely monitors all loans that are contractually 90 days past due, renegotiated or nonaccrual.



**Table of Contents**

Other real estate owned includes real estate acquired through foreclosure or by deed taken in lieu of foreclosure. These properties are recorded at estimated fair value, less costs to sell, with any difference between the fair value of the property and the carrying value of the loan being charged to the allowance for loan losses. Subsequent changes in fair value are reported as adjustments to the carrying amount, not to exceed the initial carrying value of the assets at the time of transfer. Those subsequent changes, as well as any gains or losses recognized on the sale of these properties, are included in noninterest income or noninterest expense.

	June 30, 2008	December 31, 2007
	(Dollars in thousands)	
<b>Nonaccrual loans:</b>		
Commercial, financial and agricultural	\$ 2,414	\$ 2,467
Commercial real estate	16,535	6,374
Real estate construction	240,872	96,397
Residential real estate	34,090	15,993
Consumer and other	905	655
<b>Total nonaccrual loans*</b>	<b>294,816</b>	121,886
<b>Other real estate owned and repossessions</b>	<b>113,604</b>	15,760
<b>Total nonperforming assets*</b>	<b>\$ 408,420</b>	\$ 137,646
Allowance as a percent of nonperforming assets*	60%	174%
Aggregate loans contractually past due 90 days or more for which interest is still accruing	\$ 31,337	\$ 23,837
Net charge-offs quarter-to-date	\$ 72,786	\$ 33,895
Net charge-offs year-to-date	\$ 106,379	\$ 54,066
Total nonperforming assets* as a percent of loans, other real estate and repossessions	2.62%	0.86%
Allowance as a percent of loans	1.60%	1.50%
Allowance as a percent of nonperforming loans*	84%	196%

\* Does not include loans contractually past due 90 days or more which are still accruing interest.

The increase in nonperforming assets in 2008 was primarily caused by the downturn in the residential real estate market which negatively impacted the liquidity of a number of borrowers. Refer to the *Allowance for Loan Losses* discussion in the *Risk Management* section of Management's Discussion and Analysis for additional information.

Impaired loans totaled \$263.9 million and \$105.4 million at June 30, 2008, and December 31, 2007 respectively. The related allowance for loan losses on impaired loans was \$33.5 million at June 30, 2008 compared with \$11.0 million at December 31, 2007. Substantially all of the impaired loans were on nonaccrual status, and as such were included in nonperforming assets.

In addition to nonperforming assets, the Company is aware of a number of potential problem loans where possible credit problems of borrowers cause management to have concerns as to the ability of such borrowers to comply with present loan repayment terms and which may result in these loans being classified as nonperforming in the future. There were \$491.5 million of potential problem loans identified at June 30, 2008 compared to \$542.0 million at March 31, 2008. Although these loans have been identified as potential problem loans, they may never become delinquent, nonperforming or impaired. Additionally, these loans are generally secured by real estate or other assets, thus reducing the potential for loss should they become nonperforming. Potential problem loans are considered in the determination of the adequacy of the allowance for loan losses.

As noted in the preceding data, a large percentage of the Company's loan losses and nonperforming loans have been concentrated in the residential real estate related loan portfolios; whereas most commercial real estate assets have remained generally stable. If market conditions deteriorate thereby placing pressure on the commercial real estate market, Colonial's commercial real estate loan portfolio could be adversely impacted.





## **Table of Contents**

### **Asset/Liability Management**

Asset/liability management (ALM) involves the evaluation, monitoring and management of interest rate risk, liquidity and funding. The Board of Directors has overall responsibility for Colonial's ALM policies. To ensure adherence to these policies, the Risk Committee of the Board of Directors establishes and monitors guidelines to control the sensitivity of earnings to changes in interest rates. The guidelines apply to both on- and off-balance sheet positions. The goal of ALM is to maximize earnings while carefully controlling interest rate risk.

### **Interest Rate Risk**

Interest rate risk, and its potential effect on earnings, is inherent in the operation of a financial institution. BancGroup is subject to interest rate risk because:

Assets and liabilities may mature or re-price at different times (for example, if assets re-price faster than liabilities and interest rates are generally falling, earnings will initially decline);

Assets and liabilities may re-price at the same time but by different amounts (for example, when the general level of interest rates is falling, Colonial Bank may reduce rates paid on checking and savings deposit accounts by an amount that is less than the general decline in market interest rates);

Short-term and long-term market interest rates may change by different amounts (for example, the shape of the yield curve may affect new loan yields and funding costs differently); or

The remaining maturity of various assets or liabilities may shorten or lengthen as interest rates change (for example, if long-term mortgage interest rates decline sharply, mortgage-backed securities held in the securities available for sale portfolio may prepay significantly earlier than previously anticipated which could reduce portfolio income). In addition, interest rates may have an indirect impact on loan demand, credit losses, mortgage origination volume, the value of BancGroup's pension asset/liability and other sources of earnings.

ALM activities include lending, accepting and placing deposits, investing in securities, issuing debt and hedging interest rate risk. Sensitivity of earnings to interest rate changes arises when yields on assets change in a different time period or in a different amount from interest cost on liabilities. To mitigate interest rate risk, the structure of the balance sheet is managed so that movements of interest rates on assets and liabilities are highly correlated in a manner intended to allow Colonial's interest bearing assets and liabilities to contribute to earnings even in periods of volatile interest rates.

Colonial employs the following measurement techniques in the management of interest rate risk: simulation of earnings and simulation of the economic value of equity. These techniques are complementary and are used in concert to provide a comprehensive interest rate risk management capability.

Simulation of earnings is the primary tool used to measure the sensitivity of earnings to interest rate changes. Using computer modeling techniques, Colonial is able to measure the potential impact of different interest rate assumptions on pre-tax earnings. All balance sheet positions, including derivative financial instruments, are included in the model simulation.

**Table of Contents**

The following table represents the output from the Company's simulation model based on the balance sheet at June 30, 2008 with comparable information for December 31, 2007. The table measures, consistently for both quarters, the impact on net interest income of an immediate and sustained change in all market interest rates in 100 basis point increments for the 12 calendar months following the date of the change. This twelve-month projection of net interest income under these scenarios is compared to the twelve-month net interest income projection with rates unchanged.

	Fed Funds Rate		Percentage Change in 12 Month Projected Net Interest Income Versus Projected Net Interest Income Under No Rate Change(1)	
	June 30, 2008	December 31, 2007	June 30, 2008	December 31, 2007
	<b>Basis Points Change</b>			
+200	4.00	6.25	1.8%	3.0%
+100	3.00	5.25	1.0%	2.1%
No rate change	2.00	4.25		
-100	1.00	3.25	1.5%	(2.0)%

- (1) The computation of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, estimates of rates on loans and deposits given these rate changes, the ability to maintain interest rate floors on loans as market rates decline, deposit decay rates and loan/investment prepayments. Further, the computations do not take into account changes to the slope of the yield curve, changes in the relative relationship of various market rates, changes in the volume or mix of assets and liabilities on the balance sheet nor do they contemplate any actions BancGroup could undertake in response to changes in interest rates.

As shown in the tables, the Company's balance sheet became less asset sensitive in the up rates scenarios from December 31, 2007. The change in the sensitivity in the up rates scenarios is a function of in-the-money floors on mortgage warehouse assets. These floors are in-the-money in the base scenario and therefore do not increase the full amount of the up rates change. The improvement in the down rates scenario is a function of floored mortgage warehouse assets which effectively have a fixed rate in the down scenario as market rates are below the strike rates on these assets.

**Liquidity and Funding**

Liquidity is the ability of an organization to meet its financial commitments and obligations on a timely basis. These commitments and obligations include credit needs of customers, withdrawals by depositors, repayment of debt when due and payment of operating expenses and dividends. Management of liquidity also includes management of funding sources and their utilization based on current, future and contingency needs. Maintaining and managing adequate liquidity and funding are other prominent focuses of ALM. The Company expects its liquidity needs to be met by deposit growth and through wholesale funding sources.

Deposit growth remains a primary focus of BancGroup's funding and liquidity strategy. Colonial's period end deposits comprise 79% of the Company's total funding sources and fund 70% of the Company's total assets at June 30, 2008. Total average deposits for the six months ended June 30, 2008 increased \$2.6 billion, or 16.3%, over the same period of the prior year. Excluding brokered time deposits, total average deposits for the six months ended June 30, 2008 increased \$1.4 billion, or 9.0%, over the same period of the prior year. With branches in four states where the population is expected to grow twice as fast as the rest of the United States, retail deposits have been, and are expected to continue to be, a major component of BancGroup's funding growth. However, intense competition for retail deposits has increased the cost of deposits above certain wholesale sources.

## **Table of Contents**

At June 30, 2008 and December 31, 2007, the Company had estimated available wholesale funding in excess of \$5 billion. BancGroup has worked to expand the availability of short-term and long-term wholesale funding sources to complement its core deposit base. The Company draws on a variety of funding sources to assist in funding earning asset growth and managing deposit fluctuations. Federal funds lines, collateralized funding facilities and brokered time deposits are sources for short-term borrowings. Availability from the FHLB is also an important part of BancGroup's wholesale funding. From time to time, BancGroup has issued REIT preferred securities, subordinated debentures, subordinated notes, junior subordinated debt and common stock and has utilized brokered time deposits to provide both capital and long-term funding.

### **Operational Risk Management**

In providing banking services, Colonial processes cash, checks, wires and ACH transactions which expose Colonial to operational risk. Controls over such processing activities are closely monitored to safeguard the assets of Colonial and its customers. However, from time to time, Colonial has incurred losses related to these processes, and there can be no assurance that such losses will not occur in the future.

Operational risk is the risk of losses attributable to human error, systems failures, fraud or inadequate internal controls and procedures. This risk is mitigated through a system of internal controls that are designed to keep operational risk at levels appropriate to Colonial's corporate standards in view of the risks inherent in the markets in which Colonial operates. The system of internal controls includes policies and procedures that require the proper authorization, approval, documentation and monitoring of transactions. Each business unit is responsible for complying with corporate policies and procedures. Colonial's internal auditors monitor the overall effectiveness of the system of internal controls on an ongoing basis.

Colonial does not engage in business processes that are out of its primary areas of expertise but rather outsources non-core processing functions to limit operational risk associated with non-core business.

Operational losses are monitored closely and historically have had no material impact to earnings or capital.

## **CAPITAL MANAGEMENT**

### **Capital Adequacy and Resources**

Management is committed to maintaining capital at a level sufficient to protect shareholders and depositors, provide for reasonable growth and fully comply with all regulatory requirements. Management's strategy to achieve these goals is to retain sufficient earnings while providing a reasonable return to shareholders in the form of dividends and return on equity. Dividend rates are determined by the Board of Directors in consideration of several factors including current and projected capital ratios, liquidity and income levels and other bank dividend yields and payment ratios.

The amount of a cash dividend, if any, rests with the discretion of the Board of Directors as well as upon applicable statutory constraints such as the Delaware law requirement that dividends may be paid only out of capital surplus and net profits for the fiscal year in which the dividend is declared and the preceding fiscal year.

BancGroup also has access to equity capital markets through both public and private issuances. Management considers these sources and related return in addition to internally generated capital in evaluating future expansion or acquisition opportunities.

**Table of Contents**

The Federal Reserve Board has issued guidelines identifying minimum Tier I leverage ratios relative to total assets and minimum capital ratios relative to risk-adjusted assets. The minimum leverage ratio required for BancGroup is 4%. The minimum risk adjusted capital ratios established by the Federal Reserve are 4% for Tier I and 8% for total capital. Higher capital ratios may be required by the Federal Reserve if warranted by the circumstance or risk profile. BancGroup's actual capital ratios and the components of capital and risk adjusted asset information (subject to regulatory review) are stated below:

	June 30, 2008	December 31, 2007
	(Dollars in thousands)	
<b>Risk-Based Capital:</b>		
Shareholders' equity	\$ 2,421,992	\$ 2,273,571
Unrealized losses on securities available-for-sale	162,327	3,673
Net impact of cash flow hedges and actuarial gains	(2,428)	741
Qualifying minority interests in consolidated subsidiaries	293,972	293,812
Qualifying trust preferred securities	105,000	105,000
Intangible assets (net of allowed deferred taxes)	(1,048,300)	(1,053,822)
Other adjustments	(4,071)	(3,304)
<b>Tier I Capital</b>	<b>1,928,492</b>	<b>1,619,671</b>
Allowable loan loss and unfunded commitment reserves	238,258	239,845
Subordinated debt	531,167	310,805
<b>Tier II Capital</b>	<b>769,425</b>	<b>550,650</b>
<b>Total Capital</b>	<b>\$ 2,697,917</b>	<b>\$ 2,170,321</b>
<b>Risk-Adjusted Assets</b>	<b>\$ 19,050,417</b>	<b>\$ 19,715,951</b>
<b>Quarterly Average Assets (for regulatory purposes)</b>	<b>\$ 26,143,897</b>	<b>\$ 24,266,011</b>
<b>Tier I Leverage Ratio</b>	<b>7.38%</b>	<b>6.67%</b>
<b>Risk-Adjusted Capital Ratios:</b>		
<b>Tier I Capital Ratio</b>	<b>10.12%</b>	<b>8.22%</b>
<b>Total Capital Ratio</b>	<b>14.16%</b>	<b>11.01%</b>

**Common Stock Offering**

On April 25, 2008, the Company completed a public common stock offering of 43.7 million shares at \$8.00 per share for \$350 million. The Company received proceeds of \$333.9 million, which is net of all expenses, commissions and underwriters' discounts. The Company will use the proceeds for general corporate purposes as well as investments in subsidiaries.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The information required by this item is included in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Item 4. Controls and Procedures**

The Company's management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based on this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There were no significant changes in internal control over financial reporting during the quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's disclosure controls and procedures. See the certifications by the Company's Chief Executive Officer and Chief Financial Officer filed as Exhibits 31.1 and 31.2 to this Report.



---

**Table of Contents**

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings** See Notes to the Unaudited Consolidated Financial Statements Note 8 **Commitments and Contingent Liabilities**

**Item 1A. Risk Factors**

The Company has identified the following additional risk factors that should be considered along with the risk factors included in BancGroup's Annual Report on Form 10-K for the year ended December 31, 2007:

*As a financial services company, our business and earnings are significantly affected by general business and economic conditions, particularly in the real estate industry, and accordingly, our business and earnings could be harmed in the event of an economic slowdown or recession or a market downturn or disruption.*

Our business and earnings are sensitive to general business, economic and market conditions in the United States. These conditions include changes in short-term and long-term interest rates, inflation, deflation, fluctuation in the real estate and debt capital markets, developments in national and regional economies and changes in government policies and regulations.

Our business and earnings are particularly sensitive to economic and market conditions affecting the real estate industry because most of our loan portfolio consists of commercial real estate, construction and residential loans. While generally containing lower risk than unsecured loans, commercial real estate and construction loans generally involve higher credit risk than conventional single-family residential loans. Such loans generally involve larger individual loan balances. In addition, real estate construction loans may be affected to a greater extent than residential loans by adverse conditions in real estate markets or the economy because many real estate construction borrowers' ability to repay their loans is dependent on successful development of their properties, as well as the factors affecting residential real estate borrowers. Risk of loss on a construction loan depends largely upon whether the initial estimate of the property's value at completion of construction equals or exceeds the cost of property construction (including interest) and the availability of permanent take-out financing. During the construction phase, a number of factors can result in delays and cost overruns. Construction and commercial real estate loans also involve greater risk because they may not be fully amortizing over the loan period, but have a balloon payment due at maturity. A borrower's ability to make a balloon payment may depend on the borrower being able to refinance the loan, timely sell the underlying property or liquidate other assets.

Any sustained period of weakness or weakening business or economic conditions in the markets in which we do business or in related markets could result in a decrease in the demand for loans, a reduction in the value of the real estate assets securing loans that we hold or an increase in the number of borrowers who become delinquent or default on their loans, any of which could adversely affect our results of operations and financial condition, including the value of our intangible assets. An increase in the number of delinquencies or defaults could result in a higher level of nonperforming assets, net charge-offs and provision for loan losses, which could adversely affect our results of operations.

*Our allowance for loan losses may not be adequate to cover actual loan losses, which may require us to take a charge to our earnings and adversely impact our financial condition and results of operations.*

We maintain an allowance for estimated loan losses that we believe is adequate for absorbing any probable losses in our loan portfolio. Management determines the provision for loan losses based upon an analysis of general market conditions, credit quality of our loan portfolio, and performance of our customers relative to their financial obligations with us. The amount of future losses is susceptible to changes in economic, operating, and other conditions, including changes in interest rates that may be beyond our control and such losses may exceed the allowance for estimated loan losses. Although management believes that the allowance for estimated loan losses is adequate to absorb any probable losses on existing loans that may become uncollectible, there can be no assurance that the allowance will prove sufficient to cover actual loan losses in the future. Significant increases to

**Table of Contents**

the provisions for loan losses may be necessary if material adverse changes in general economic conditions occur or the performance of our loan portfolio deteriorates. Additionally, banking regulators, as an integral part of their supervisory function, periodically review the allowance for estimated loan losses. If these regulatory agencies require us to increase the allowance for estimated loan losses, it could have a negative effect on our results of operations and financial condition.

*We may be required to raise additional capital in the future, but that capital may not be available when it is needed, which could adversely affect our financial condition and results of operations.*

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future. We may at some point, however, need to raise additional capital to maintain such levels and/or support our growth.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations could be materially impaired.

*Conditions in the financial markets may limit our access to additional short-term funding to meet our liquidity needs.*

We anticipate that our current sources of liquidity, which include deposits, Federal Home Loan Bank advances, cash on hand and short-term borrowings will remain adequate to meet our liquidity needs. However, the limited availability of liquidity as a result of the subprime mortgage crisis may require us to make short-term borrowings, if needed, on terms and conditions that adversely affect our results of operations.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds Issuer purchases of equity securities N/A**

**Item 3. Defaults Upon Senior Securities N/A**



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

On April 16, 2008, the annual meeting of the shareholders of Colonial BancGroup was held. The following numbered matters were considered by the shareholders and the following tables list the results of the shareholders' votes. With respect to the election of directors, the table indicates the votes cast for or withheld for each director, and the percentage of the votes cast for each director out of the number of votes cast. With respect to the other matters, each table indicates the votes abstaining or cast for or against a particular matter, and the percentage of votes cast for the matter out of the total outstanding or the total number of votes cast, as appropriate.

1. To elect the nominees named in the Proxy Statement as directors to serve terms of three years as set out therein.  
The following directors were elected for a term expiring in 2011:

	For	Withheld	Percent For
Augustus K. Clements	130,726,754	3,029,307	97.7%
Patrick F. Dye	129,368,508	4,387,553	96.7%
Milton E. McGregor	130,400,830	3,355,231	97.5%
William E. Powell, III	130,631,578	3,124,483	97.7%
Simuel Sippial, Jr.	130,499,990	3,256,071	97.6%

In addition to the foregoing, the following directors will continue to serve:

Directors whose terms expire in 2010: Robert S. Craft, Hubert L. Harris, Jr., Clinton O. Holdbrooks, Robert E. Lowder, John C.H. Miller, Jr., James W. Rane

Directors whose terms expire in 2009: Lewis E. Beville, Deborah L. Linden, John Ed Mathison, Joe D. Mussafer, Edward V. Welch

2. To ratify the appointment of PricewaterhouseCoopers, LLP as BancGroup's independent auditor for 2008:

FOR	AGAINST	ABSTAIN	Percent FOR out of Total Votes Cast
131,045,416	2,485,592	225,053	98.0%

3. To approve the amended Stock Plan for Directors:

FOR	AGAINST	ABSTAIN	Percent FOR out of Total Votes Cast
122,602,115	10,352,468	801,478	91.7%

4. To approve the amended Management Incentive Plan:

FOR	AGAINST	ABSTAIN	Percent FOR out of Total Votes Cast
118,052,517	14,959,845	743,699	88.3%

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

5. To vote on the shareholder proposed resolution to declassify the Board:

<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>	<b>NOT VOTED</b>	<b>Percent FOR out of Total Votes Cast</b>
56,325,394	41,186,462	1,606,526	34,637,679	42.1%

59

**Table of Contents****Item 5. Other Information****Certain Regulatory Considerations**

Colonial Bank converted from a national banking association to an Alabama state-chartered non-member bank on June 10, 2008. Colonial Bank as a state-chartered non-member bank is subject to substantially similar laws and regulations as a national banking association. Therefore, the discussion of Colonial Bank's and BancGroup's regulatory considerations in BancGroup's Annual Report on Form 10-K for the year ended December 31, 2007 is still substantially correct. However, any reference to Colonial Bank being a national banking association should now be read to reference Colonial Bank as a state-chartered non-member bank. Any reference to Colonial Bank being regulated by the Office of the Comptroller of the Currency should now be read to reference Colonial Bank as being regulated by the Alabama State Banking Department and the Federal Deposit Insurance Corporation. All banks, including Colonial Bank, are subject to a regulatory assessment by their chartering authority. This will now be paid to the Alabama State Banking Department whereas before it was paid to the Office of the Comptroller of the Currency.

**Item 6. Exhibits**

Exhibits required by Item 601 of Regulation S-K

**Exhibit**

- |      |   |
|------|---|
| 1.1  | Underwriting agreement dated February 28, 2008, between The Colonial BancGroup, Inc. and the underwriters, filed as exhibit 1.1 to the Registrant's Current Report on Form 8-K, dated March 5, 2008, and incorporated herein by reference.  |
| 4.1  | Indenture from The Colonial BancGroup, Inc. to The Bank of New York Trust Company, N.A., Trustee, relating to the 8.875% Subordinated Notes due 2038 dated March 1, 2008, filed as exhibit 4.1 to the Registrant's Current Report on Form 8-K, dated March 5, 2008, and incorporated herein by reference. |
| 4.2  | Form of the Subordinated Notes due 2038, filed as exhibit 4.2 to the Registrant's Current Report on Form 8-K, dated March 5, 2008, and incorporated herein by reference.  |
| 4.3  | Dividend Reinvestment and Common Stock Purchase Plan of Registrant dated May 2, 2008, filed as the Registrant's Registration Statement on Form S-3 (File No. 333-150623), filed and made effective May 2, 2008 and incorporated herein by reference.  |
| 10.1 | The Colonial BancGroup, Inc. Stock Plan for Directors, as amended, filed as exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q, dated May 5, 2008, and incorporated herein by reference.  |
| 10.2 | The Colonial BancGroup, Inc. Management Incentive Plan, as amended, filed as exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q, dated May 5, 2008, and incorporated herein by reference.   |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certifications of the Chief Executive Officer.   |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certifications of the Chief Financial Officer.   |
| 32.1 | Rule 13a-14(b) Certifications of the Chief Executive Officer.   |
| 32.2 | Rule 13a-14(b) Certifications of the Chief Financial Officer.   |

**Table of Contents**

**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) 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, in the City of Montgomery, Alabama, on the 5th day of August, 2008.

THE COLONIAL BANCGROUP, INC.

By: /s/ SARAH H. MOORE  
**Sarah H. Moore**

**Chief Financial Officer**