

COLONIAL BANCGROUP INC

Form 10-Q

November 06, 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 September 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 BANCGROUP, 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
Common Stock, \$2.50 Par Value

Outstanding at October 31, 2008
202,432,910

Table of Contents**THE COLONIAL BANGROUP, INC. AND SUBSIDIARIES****INDEX**

| | Page Number |
|--|------------------------|
| <u>PART I. FINANCIAL INFORMATION</u> | |
| Item 1. <u>Financial Statements (Unaudited)</u> | 4 |
| <u>Consolidated Statements of Condition September 30, 2008 and December 31, 2007</u> | 4 |
| <u>Consolidated Statements of Income Three months ended September 30, 2008 and September 30, 2007, and nine months ended September 30, 2008 and September 30, 2007</u> | 5 |
| <u>Consolidated Statements of Comprehensive Income Three months ended September 30, 2008 and September 30, 2007, and nine months ended September 30, 2008 and September 30, 2007</u> | 6 |
| <u>Consolidated Statement of Changes in Shareholders' Equity Nine months ended September 30, 2008</u> | 7 |
| <u>Consolidated Statements of Cash Flows Nine months ended September 30, 2008 and September 30, 2007</u> | 8 |
| <u>Notes to the Unaudited Consolidated Financial Statements September 30, 2008</u> | 9 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 29 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 62 |
| Item 4. <u>Controls and Procedures</u> | 62 |
| <u>PART II. OTHER INFORMATION</u> | |
| Item 1. <u>Legal Proceedings</u> | 63 |
| Item 1A. <u>Risk Factors</u> | 63 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 64 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 64 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 64 |
| Item 5. <u>Other Information</u> | 64 |
| Item 6. <u>Exhibits</u> | 65 |
| <u>SIGNATURE</u> | 66 |

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 or on BancGroup's website at www.colonialbank.com), the following factors, among others, could cause actual results to differ materially from forward-looking statements, and future results could differ materially from historical performance. These factors are not exclusive:

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 and the impact of our results of operations 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;

continued or sustained deterioration of market and economic conditions or business performance could increase the likelihood that we would have to record a significant goodwill impairment charge;

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;

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

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)**

| | September 30, 2008 | December 31, 2007 |
|---|---|----------------------|
| | (In thousands, except share amounts) | |
| ASSETS | | |
| Cash and due from banks | \$ 1,328,493 | \$ 474,948 |
| Interest bearing deposits in banks | 669 | 28,993 |
| Federal funds sold | 7,096 | 71,167 |
| Securities purchased under agreements to resell | 1,493,585 | 2,049,664 |
| Securities available for sale | 3,619,509 | 3,681,282 |
| Held to maturity securities (fair value: 2008, \$209,807; 2007, \$1,361) | 206,014 | 1,228 |
| Loans held for sale (includes \$1,873,985 measured at fair value at September 30, 2008) | 2,060,709 | 1,544,222 |
| Total loans, net of unearned income: | 15,168,356 | 15,923,178 |
| Less: Allowance for loan losses | (285,000) | (238,845) |
| Loans, net | 14,883,356 | 15,684,333 |
| Premises and equipment, net | 507,167 | 500,558 |
| Goodwill | 1,007,053 | 1,008,168 |
| Other intangible assets, net | 53,763 | 63,437 |
| Other real estate owned | 134,893 | 15,760 |
| Bank-owned life insurance | 490,585 | 475,593 |
| Accrued interest and other assets | 469,679 | 376,636 |
| Total | \$ 26,262,571 | \$ 25,975,989 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest bearing transaction accounts | \$ 2,843,971 | \$ 2,988,457 |
| Interest bearing transaction accounts | 5,232,769 | 6,783,116 |
| Total transaction accounts | 8,076,740 | 9,771,573 |
| Time deposits | 8,707,034 | 7,317,108 |
| Brokered time deposits | 1,709,159 | 1,455,586 |
| Total deposits | 18,492,933 | 18,544,267 |
| Repurchase agreements | 458,658 | 568,721 |
| Federal funds purchased | | |
| Other short-term borrowings | 300,000 | |
| Subordinated debt | 610,716 | 386,434 |
| Junior subordinated debt | 108,248 | 108,256 |
| Other long-term debt | 3,319,711 | 3,529,146 |
| Accrued expenses and other liabilities | 290,290 | 272,536 |
| Total liabilities | 23,580,556 | 23,409,360 |
| Minority interest/REIT preferred securities | 293,058 | 293,058 |
| Contingencies and commitments (Note 8) | | |

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

| | | | |
|---|----------------------|---------------|--|
| Preferred stock, \$2.50 par value; 50,000,000 shares authorized and none issued at both September 30, 2008 and December 31, 2007 | | | |
| Preference stock, \$2.50 par value; 1,000,000 shares authorized and none issued at both September 30, 2008 and December 31, 2007 | | | |
| Common stock, \$2.50 par value; 400,000,000 shares authorized; 212,317,639 and 167,407,169 shares issued and 202,350,912 and 157,440,442 shares outstanding at September 30, 2008 and December 31, 2007, respectively | 530,794 | 418,518 | |
| Additional paid in capital | 1,232,020 | 1,004,888 | |
| Retained earnings | 970,442 | 1,094,916 | |
| Treasury stock, at cost; 9,966,727 shares at both September 30, 2008 and December 31, 2007 | (240,336) | (240,336) | |
| Accumulated other comprehensive loss, net of taxes | (103,963) | (4,415) | |
| | | | |
| Total shareholders' equity | 2,388,957 | 2,273,571 | |
| | | | |
| Total | \$ 26,262,571 | \$ 25,975,989 | |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|----------------|------------------------------------|------------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In thousands, except per share amounts) | | | |
| Interest Income: | | | | |
| Interest and fees on loans | \$ 255,046 | \$ 325,696 | \$ 827,323 | \$ 966,184 |
| Interest and dividends on securities | 53,871 | 43,246 | 158,474 | 120,945 |
| Interest on federal funds sold and other short-term investments | 27,500 | 26,592 | 81,897 | 69,158 |
| Total interest income | 336,417 | 395,534 | 1,067,694 | 1,156,287 |
| Interest Expense: | | | | |
| Interest on deposits | 117,401 | 142,217 | 375,314 | 414,370 |
| Interest on short-term borrowings | 3,049 | 14,301 | 23,424 | 51,863 |
| Interest on long-term debt | 49,218 | 43,005 | 146,159 | 123,881 |
| Total interest expense | 169,668 | 199,523 | 544,897 | 590,114 |
| Net Interest Income | 166,749 | 196,011 | 522,797 | 566,173 |
| Provision for loan losses | 159,399 | 4,800 | 273,942 | 13,155 |
| Net Interest Income After Provision for Loan Losses | 7,350 | 191,211 | 248,855 | 553,018 |
| Noninterest Income: | | | | |
| Service charges on deposit accounts | 19,645 | 19,376 | 58,132 | 55,749 |
| Electronic banking | 5,149 | 4,923 | 15,428 | 13,972 |
| Other retail banking fees | 2,209 | 2,794 | 7,297 | 9,661 |
| Retail banking fees | 27,003 | 27,093 | 80,857 | 79,382 |
| Mortgage banking origination and sales | 8,095 | 3,236 | 22,808 | 10,083 |
| Wealth management services | 4,370 | 4,506 | 14,243 | 12,611 |
| Mortgage warehouse fees | 1,467 | 5,936 | 3,713 | 19,223 |
| Bank-owned life insurance | 4,720 | 5,070 | 15,009 | 15,027 |
| Securities and derivatives gains (losses), net | (6,057) | | 3,043 | 2,097 |
| Securities restructuring charges | | | | (36,006) |
| Gain on sale of mortgage loans | | | | 3,850 |
| Gain on sale of merchant services | | | | 4,900 |
| Other income | 6,042 | 7,117 | 19,437 | 15,791 |
| Total noninterest income | 45,640 | 52,958 | 159,110 | 126,958 |
| Noninterest Expense: | | | | |
| Salaries and employee benefits | 75,129 | 68,345 | 223,557 | 208,155 |
| Occupancy expense of bank premises, net | 24,177 | 19,634 | 71,296 | 56,861 |
| Furniture and equipment expenses | 15,215 | 13,226 | 45,052 | 39,698 |
| Professional services | 7,252 | 4,967 | 20,697 | 13,695 |
| FDIC insurance and other regulatory fees | 4,169 | 1,727 | 13,145 | 4,173 |
| Amortization of intangible assets | 4,154 | 3,500 | 12,459 | 9,752 |
| Electronic banking and other retail banking expenses | 3,479 | 5,766 | 11,772 | 15,485 |
| Loan and real estate related costs | 4,550 | 1,170 | 11,685 | 2,407 |

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

| | | | | |
|--|--------------------|------------------|--------------------|-------------------|
| Communications | 2,799 | 2,677 | 8,481 | 8,568 |
| Advertising | 3,440 | 1,570 | 8,427 | 7,468 |
| Postage and courier | 2,373 | 2,589 | 7,265 | 7,920 |
| Loss on equity investments | 4,995 | 660 | 9,462 | 1,585 |
| Travel | 1,572 | 1,586 | 4,533 | 5,275 |
| Severance expense | | 500 | 786 | 4,045 |
| Merger related expenses | | 753 | | 2,298 |
| Net losses related to the early extinguishment of debt | 284 | | 10,327 | 6,908 |
| Other expenses | 8,851 | 6,281 | 31,640 | 20,283 |
| Total noninterest expense | 162,439 | 134,951 | 490,584 | 414,576 |
| Minority interest expense/REIT preferred dividends | 5,336 | 5,336 | 16,008 | 7,648 |
| Income (loss) before tax | (114,785) | 103,882 | (98,627) | 257,752 |
| Income tax expense (benefit) | (43,575) | 34,527 | (43,258) | 85,799 |
| Net Income (Loss) | \$ (71,210) | \$ 69,355 | \$ (55,369) | \$ 171,953 |
| Earnings (Loss) per share: | | | | |
| Basic | \$ (0.35) | \$ 0.45 | \$ (0.30) | \$ 1.12 |
| Diluted | \$ (0.35) | \$ 0.45 | \$ (0.30) | \$ 1.11 |
| Average number of shares outstanding: | | | | |
| Basic | 200,757 | 153,536 | 182,216 | 153,358 |
| Diluted | 200,757 | 154,320 | 182,216 | 154,310 |
| Dividends declared per share | \$ 0.095 | \$ 0.1875 | \$ 0.38 | \$ 0.5625 |

See Notes to the Unaudited Consolidated Financial Statements

Table of Contents

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

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In thousands) | | | |
| Net income (loss) | \$ (71,210) | \$ 69,355 | \$ (55,369) | \$ 171,953 |
| Other comprehensive income(loss), net of taxes: | | | | |
| Available for sale securities: | | | | |
| Unrealized gains (losses) on securities available for sale arising during the period, net of income taxes of \$(28,317) and \$54,496 in 2008 and \$(7,433) and \$5,533 in 2007, respectively | 52,589 | 15,742 | (102,427) | (8,338) |
| Less: reclassification adjustment for net (gains) losses on securities available for sale included in net income, net of income taxes of \$(1,801) and \$636 in 2008 and \$0 and \$(11,867) in 2007, respectively | 3,348 | | (290) | 22,042 |
| Cash flow hedging instruments: | | | | |
| Reclassification adjustment for losses included in net income, net of income taxes of \$0 and \$(1,707) in 2008 and \$(853) and \$(2,560) in 2007, respectively | | 1,585 | 3,169 | 4,754 |
| Comprehensive income(loss) | \$ (15,273) | \$ 86,682 | \$ (154,917) | \$ 190,411 |

See Notes to the Unaudited Consolidated Financial Statements

Table of Contents

THE COLONIAL BANGROUP, 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 | 28,235 | 71 | 435 | | | | 506 |
| Stock option plans | 50,700 | 127 | 489 | | | | 616 |
| Restricted stock plan, net | 1,078,703 | 2,697 | (2,697) | | | | |
| Employee stock purchase plan | 37,937 | 94 | 231 | | | | 325 |
| Dividend reinvestment plan | 14,449 | 36 | 114 | | | | 150 |
| Common stock offering | 43,700,446 | 109,251 | 224,721 | | | | 333,972 |
| Tax benefit (shortfall) from stock based compensation | | | (59) | | | | (59) |
| Stock-based compensation expense | | | 3,898 | | | | 3,898 |
| Net income (loss) | | | | | (55,369) | | (55,369) |
| Cash dividends (\$0.38 per share) | | | | | (68,434) | | (68,434) |
| Change in unrealized loss on securities available for sale, net of taxes and reclassification adjustments | | | | | | (102,717) | (102,717) |
| Reclassification of cash flow hedging losses, net of taxes | | | | | | 3,169 | 3,169 |
| Balance, September 30, 2008 | 202,350,912 | \$ 530,794 | \$ 1,232,020 | \$ (240,336) | \$ 970,442 | \$ (103,963) | \$ 2,388,957 |

See Notes to the Unaudited Consolidated Financial Statements

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

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------|
| | 2008 | 2007 |
| | (In thousands) | |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (55,369) | \$ 171,953 |
| Adjustments to reconcile net income (loss) to net cash from operating activities: | | |
| Depreciation, amortization and accretion | 44,257 | 29,889 |
| Provision for loan losses | 273,942 | 13,155 |
| Deferred taxes | (5,847) | 3,378 |
| Securities and derivatives gains (losses), net | (3,043) | (2,097) |
| Securities restructuring losses | | 36,006 |
| Gain on sale of mortgage loans | | (3,850) |
| Gain on sale of other assets | (8,398) | (5,704) |
| Net (increase) decrease in loans held for sale | (514,105) | 230,735 |
| (Increase) decrease in interest and other receivables | 32,419 | (15,951) |
| (Increase) decrease in prepaids | 5,955 | (7,491) |
| (Increase) decrease in other assets | 731 | 14,219 |
| Increase (decrease) in other liabilities | 21,825 | 14,262 |
| Increase (decrease) in accrued income taxes | (60,540) | (7,891) |
| Increase (decrease) in interest payable | (1,368) | 8,359 |
| Excess tax benefit from stock based compensation | (17) | (915) |
| Other, net | (1,793) | (8,552) |
| Net cash from operating activities | (271,351) | 469,505 |
| Cash flows from investing activities: | | |
| Proceeds from maturities and calls of securities available for sale | 78,971 | 139,925 |
| Proceeds from sales of securities available for sale | 293,959 | 1,647,519 |
| Purchases of securities available for sale | (465,866) | (1,947,072) |
| Proceeds from maturities of held to maturity securities | 944 | 616 |
| Purchases of held to maturity securities | (205,741) | |
| Net (increase) decrease in securities purchased under agreements to resell | 559,104 | (1,469,324) |
| Net (increase) decrease in loans excluding proceeds from sale of loans | 331,903 | 356,086 |
| Proceeds from sales of loans | 53,347 | 493,101 |
| Net cash paid in bank acquisition | | (77,309) |
| Capital expenditures | (62,190) | (92,657) |
| Proceeds from bank owned life insurance | 114 | 319 |
| Proceeds from sale of other assets | 57,125 | 88,241 |
| Net (contributions to) return of investment in affiliates | (12,706) | 2,162 |
| Net cash from investing activities | 628,964 | (858,393) |
| Cash flows from financing activities: | | |
| Net increase (decrease) in demand, savings and time deposits | (52,207) | 19,070 |
| Net increase (decrease) in federal funds purchased, repurchase agreements and other short-term borrowings | 189,937 | (793,978) |
| Proceeds from issuance of long-term debt, net | 241,971 | 1,300,000 |
| Repayment of long-term debt | (242,799) | (221,216) |
| Purchase of common stock | | (157,830) |

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

| | | |
|--|---------------------|------------|
| Proceeds from issuance of common stock | 335,052 | 6,962 |
| Proceeds from issuance of REIT preferred securities | | 293,206 |
| Excess tax benefit from stock-based compensation | 17 | 915 |
| Dividends paid | (68,434) | (86,352) |
| Net cash from financing activities | 403,537 | 360,777 |
| Net increase (decrease) in cash and cash equivalents | 761,150 | (28,111) |
| Cash and cash equivalents at the beginning of the year | 575,108 | 442,682 |
| Cash and cash equivalents at September 30 | \$ 1,336,258 | \$ 414,571 |

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 September 30, 2008 and December 31, 2007 and the results of operations and cash flows for the interim periods ended September 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

Table of Contents

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, *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*.

At adoption, 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. Acquired short-term participations in mortgage loans for which the Company has elected to apply the fair value option are carried at fair value. All other loans held for sale are carried at the lower of aggregate cost or fair value.

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 are reported in earnings. Upfront costs and fees related to those items are 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. During the third quarter of 2008, BancGroup elected the fair value option for its short-term participations in mortgage loans held for sale acquired on or after August 1, 2008. See Note 4, *Fair Value Measurements*, for further discussion.

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.

Table of Contents

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 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, and 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. Colonial is in the process of reviewing the potential impact of FAS 141(R). The adoption of FAS 141(R) could have a material impact to the consolidated financial statements for business combinations entered into after the effective date of FAS 141(R).

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

Table of Contents

years and interim periods beginning after November 15, 2008, and earlier application is permitted. Because SFAS 161 only requires additional disclosures, the adoption of the standard will not impact the Company's financial condition, results of operations or cash flows.

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 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.

In September 2008, the FASB issued FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*. This FSP amends SFAS 133 to require a seller of credit derivatives, including credit derivatives embedded in hybrid instruments, to disclose for each statement of financial position presented: the nature of the credit derivative; the maximum potential amount of future undiscounted payments the seller could be required to make under the credit derivative contract (or the fact that there is no limit to the maximum potential future payments); the fair value of the derivative; and the nature of any recourse provisions and assets held as collateral or by third parties that the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative contract. These disclosures must be provided even if the likelihood of having to make payments is remote. In addition, this FSP amends FIN 45, *Guarantors' Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, to require guarantors to disclose the current status of the payment/performance risk of a guarantee. The provisions of this FSP that amend SFAS 133 and FIN 45 are effective for annual or interim reporting periods ending after November 15, 2008. This FSP also clarifies that SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Because FSP FAS 133-1 and FIN 45-4 only requires additional disclosures, the adoption of the standard will not impact the Company's financial condition, results of operations or cash flows.

In September 2008, the SEC Office of the Chief Accountant and the FASB Staff jointly issued Release 2008-234, *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting*. Release 2008-234 provides general clarification guidance on determining fair value under SFAS 157 when markets are inactive. On October 10, 2008, the FASB Staff issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which includes guidance that is consistent with Release 2008-234. FSP FAS 157-3 amends SFAS 157 by incorporating an example to illustrate key

Table of Contents

considerations in determining the fair value of a financial asset in an inactive market. With regard to the measurement principles of SFAS 157, this FSP reaffirms the notion of fair value as an exit price as of the measurement date. Additionally, this FSP provides clarification on how management's internal cash flow and discount rate assumptions should be considered when measuring fair value when relevant observable data does not exist, how observable market information in a market that is not active should be considered when measuring fair value, and how the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value. This FSP became effective upon issuance and should be applied to prior periods for which financial statements have not been issued. BancGroup applied the guidance in Release 2008-234 and FSP FAS 157-3 when determining fair value for the Company's non-agency mortgage-backed securities as of September 30, 2008. See Note 4, *Fair Value Measurements*, for further discussion.

Note 3: Supplemental Disclosure of Cash Flow Information

| | Nine Months Ended September 30, 2008 2007 (In thousands) | |
|--|--|------------|
| Cash paid during the year for: | | |
| Interest | \$ 539,595 | \$ 569,736 |
| Income taxes | 23,896 | 77,000 |
| Non-cash investing and financing activities: | | |
| Transfer of loans to other real estate | \$ 170,317 | \$ 14,596 |
| Transfer of loans to loans held for sale | 2,382 | |
| Assets (non-cash) acquired in business combination | | 1,212,372 |
| Liabilities assumed in business combination | | 980,196 |
| Assets acquired under capital leases | 4,421 | 2,153 |
| 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 September 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) | | | |
| Assets: | | | | |
| Securities available for sale(1)(2) | \$ 3,443,936 | \$ 32 | \$ 1,899,813 | \$ 1,544,091 |
| Loans held for sale | 1,873,985 | | 1,873,985 | |
| Derivative assets | 654 | | 278 | 376 |
| Total | \$ 5,318,575 | \$ 32 | \$ 3,774,076 | \$ 1,544,467 |
| Liabilities: | | | | |
| Derivative liabilities | \$ 15,996 | \$ | \$ 443 | \$ 15,553 |

(1) Securities available for sale as of September 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) See valuation methodology used for securities available for sale as discussed below.

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

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

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 typically 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 agency mortgage-backed

Table of Contents

securities and obligations of states and political subdivisions. In the first and second quarter of 2008, BancGroup's non-agency mortgage-backed securities were classified as Level 2. During the third quarter of 2008, the Company noted that the market for these securities had become increasingly inactive. This inactivity was first evidenced by a significant widening of the bid-ask spread and then by a significant decrease in the volume of trades and new issuances relative to historical levels. Since there were few observable transactions, the prices for those transactions that had occurred were not current, and the observable prices for those transactions varied substantially over time, the Company determined that the market for its non-agency mortgage-backed securities was not active as of September 30, 2008. After considering the guidance in SEC Release 2008-234 and FSP FAS 157-3, the Company determined that multiple inputs from different sources would collectively provide the best evidence of fair value as of September 30, 2008. Therefore, fair value was determined based on consideration of current market participant expectations of future cash flows from the securities as well as based on pricing provided by a third party pricing service. The fair value provided by the third party pricing service was given a one-third weighting, while the fair value determined through discounting the related cash flows was given a two-thirds weighting. More weight was given to the fair value determined through discounting the related cash flows because (a) the quotes provided by the third party were nonbinding quotes based on the third party's own models using significant unobservable inputs, and (b) the Company was able to corroborate some of the inputs to the discounted cash flow fair value with relevant observable market data. Because of the significance of unobservable inputs to the overall value of these securities, they were transferred from Level 2 to Level 3 on September 30, 2008.

Loans held for sale During the third quarter of 2008, BancGroup elected the fair value option for its short-term participations in mortgage loans held for sale acquired on or after August 1, 2008. 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 recurring fair value adjustments are classified as Level 2.

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. Because of the significance of unobservable inputs (such as the probability of funding) to the overall value of these instruments, 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 are classified as Level 3. They were transferred to Level 3 in the second quarter.

Items Measured at Fair Value on a Recurring Basis

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

| | Net derivative assets and (liabilities) | Securities available for sale |
|---|--|----------------------------------|
| | (In thousands) | |
| Three months ended September 30, 2008: | | |
| Balance, June 30, 2008 | \$ (9,949) | \$ |
| Total gains or losses (realized/unrealized) | | |
| Included in net income(1) | (5,228) | |
| Included in other comprehensive loss | | (168,501) |
| Net transfers into Level 3 | | 1,712,592 |
| Balance, September 30, 2008 | \$ (15,177) | \$ 1,544,091 |
| Net unrealized losses included in net income relating to assets and liabilities held at September 30, 2008(1) | \$ (5,228) | \$ |

Table of Contents

(1) Approximately \$89,000 included in other noninterest income and (\$5.3) million in other noninterest expense.

| | Net derivative assets and (liabilities) | Securities available for sale (In thousands) |
|---|--|--|
| Nine months ended September 30, 2008: | | |
| Balance, January 1, 2008 | \$ | \$ |
| Total gains or losses (realized/unrealized) | | |
| Included in net income(1) | (5,047) | |
| Included in other comprehensive loss | | (168,501) |
| Net transfers into Level 3 | (10,130) | 1,712,592 |
| Balance, September 30, 2008 | \$ (15,177) | \$ 1,544,091 |
| Net unrealized losses included in net income relating to assets and liabilities held at September 30, 2008(1) | \$ (5,047) | \$ |

(1) Approximately \$257,000 included in other noninterest income and (\$5.3) million in other noninterest expense.

Items Measured at Fair Value on a Nonrecurring Basis

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 nine months of 2008 that were still held in the balance sheet at September 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.

| | Total | Carrying value at September 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) | | | | |
| Loans held for sale | \$ 83,186 | \$ | \$ 83,186 | \$ |
| Loans | 294,722 | | | 294,722 |
| Equity investments | 41,173 | | | 41,173 |

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 for which the fair value option has not been elected 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.

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

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*. 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 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.

Table of Contents

Equity investments Nonrecurring fair value adjustments on equity investments reflect impairment write-downs in accordance with Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The valuation of these investments requires significant management judgment due to the absence of quoted market prices, inherent lack of liquidity and the long-term nature of the investments; as a result, equity investments subjected to nonrecurring fair value adjustments are classified as Level 3.

During the three and nine months ended September 30, 2008, BancGroup recognized adjustments related to certain assets that are measured at fair value on a nonrecurring basis (i.e. loans, loans held for sale and equity investments). Approximately \$110.6 million and \$206.3 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 nine months ended September 30, 2008, respectively.

During the three months ended September 30, 2008, the Company recorded approximately \$13.1 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 \$12.4 million on related call options.

During the nine months ended September 30, 2008, the Company recorded approximately \$2.8 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 \$1.9 million on related call options.

During the three and nine months ended September 30, 2008, the Company recorded approximately \$2.7 million and \$5.3 million, respectively, of impairment on equity investments.

Fair Value Option

BancGroup adopted SFAS 159 on January 1, 2008. SFAS 159 permits companies to elect to measure certain eligible items at fair value, with subsequent unrealized gains and losses on those items reported in earnings. Upfront costs and fees related to those items are reported in earnings as incurred and are not deferred. The fair value option may only be elected at the time of initial recognition of a financial asset or financial liability or upon the occurrence of certain specified events. 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.

During the third quarter of 2008, BancGroup elected the fair value option for its short-term participations in mortgage loans held for sale acquired on or after August 1, 2008. This election allows for a more effective accounting offset of the changes in fair value of the loans and the call options that the Company sells in relation to these loans. BancGroup has not elected the fair value option for other loans held for sale primarily because they represent an immaterial portion of the total loans held for sale portfolio. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. At September 30, 2008, loans held for sale for which the fair value option was elected had an aggregate fair value of \$1.87 billion and an aggregate outstanding principal balance of \$1.86 billion and were recorded in loans held for sale in the consolidated balance sheet. At September 30, 2008, no loans held for sale for which the fair value option was elected were 90 days or more past due or were in nonaccrual. Interest income on short-term participations in mortgage loans held for sale is recognized based on contractual rates and is reflected in interest and fees on loans in the consolidated income statement. Net losses resulting from changes in fair value of these loans of \$8.7 million were recorded in noninterest expense during the third quarter of 2008. These changes in fair value were mostly offset by net gains of approximately \$8.1 million on related call options. An immaterial portion of these amounts was attributable to changes in instrument-specific credit risk.

Table of Contents**Note 5: Securities**

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

| | Carrying Value at September 30, 2008 | Carrying Value at December 31, 2007 |
|---|---|--|
| | (In thousands) | |
| Securities available for sale: | | |
| Agency mortgage-backed securities | \$ 1,554,428 | \$ 1,359,503 |
| Non-agency mortgage-backed securities | 1,544,091 | 1,701,047 |
| Obligations of state and political subdivisions | 345,385 | 371,930 |
| Corporate notes | | 6,819 |
| Federal Reserve and FHLB stock and other | 175,605 | 241,983 |
| Total securities available for sale | 3,619,509 | 3,681,282 |
| Held to maturity securities: | | |
| U.S. Treasury securities | 500 | 500 |
| Agency mortgage-backed securities | 205,280 | 495 |
| Obligations of state and political subdivisions | 234 | 233 |
| Total held to maturity securities | 206,014 | 1,228 |
| Total securities | \$ 3,825,523 | \$ 3,682,510 |

During the third quarter of 2008, the Company sold approximately \$5 million in securities and purchased approximately \$315 million in new securities, excluding transactions in Federal Home Loan Bank of Atlanta (FHLB) stock.

During the second quarter of 2008, the Company did not sell any securities, but did purchase approximately \$128 million in new securities, excluding transactions in 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 September 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) | | | | | |
| Agency mortgage-backed securities | \$ 109,245 | \$ (1,378) | \$ 41,321 | \$ (278) | \$ 150,566 | \$ (1,656) |
| Non-agency mortgage-backed securities | 887,972 | (79,546) | 656,119 | (88,956) | 1,544,091 | (168,502) |
| Obligations of state and political subdivisions | 298,742 | (13,050) | 335 | (3) | 299,077 | (13,053) |
| Subtotal, debt securities | 1,295,959 | (93,974) | 697,775 | (89,237) | 1,993,734 | (183,211) |
| Equity securities | 0 | (0) | 1 | (2) | 1 | (2) |
| Total temporarily impaired securities | \$ 1,295,959 | \$ (93,974) | \$ 697,776 | \$ (89,239) | \$ 1,993,735 | \$ (183,213) |

Table of Contents

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) | | | | | |
| Agency mortgage-backed securities | \$ 50,022 | \$ (562) | \$ 368,346 | \$ (3,634) | \$ 418,368 | \$ (4,196) |
| Non-agency mortgage-backed securities | 850,308 | (17,195) | 260,701 | (9,153) | 1,111,009 | (26,348) |
| 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 agency mortgage-backed securities, non-agency mortgage-backed securities, and obligations of state and political subdivisions. As of September 30, 2008 and December 31, 2007, there were 245 and 129 debt securities, respectively, carried at an unrealized loss relating to the level of interest rates prevailing in 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, the relatively high credit quality of mortgages underlying such securities, 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 and intent 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:

| | September 30, 2008 | December 31, 2007 |
|--|-----------------------|----------------------|
| | (In thousands) | |
| Commercial, financial and agricultural | \$ 1,675,774 | \$ 1,506,986 |
| Commercial real estate | 5,001,780 | 5,012,773 |
| Real estate construction | 5,448,351 | 6,296,262 |
| Residential real estate | 2,587,610 | 2,673,823 |
| Consumer and other | 471,160 | 452,642 |
| Total loans | 15,184,675 | 15,942,486 |
| Less: unearned income | (16,319) | (19,308) |
| Total loans, net of unearned income | \$ 15,168,356 | \$ 15,923,178 |

Table of Contents**Note 7: Allowance for Loan Losses**

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

| | Nine Months Ended September 30, 2008 (In thousands) |
|-----------------------------|---|
| Balance, January 1 | \$ 238,845 |
| Provision charged to income | 273,942 |
| Loans charged off | (231,878) |
| Recoveries | 4,091 |
| Balance, September 30 | \$ 285,000 |

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

Standby letters of credit are contingent commitments issued by Colonial 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 Colonial Bank receives a fee. These guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. Colonial 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 September 30, 2008 and December 31, 2007 were \$635,000 and \$823,000, respectively. At September 30, 2008, Colonial Bank had standby letters of credit outstanding with maturities of generally one year or less. The maximum potential amount of future undiscounted payments Colonial Bank could be required to make under outstanding standby letters of credit at September 30, 2008 was \$196 million.

In connection with the sale of certain loans and related assets, Colonial makes representations, warrants and indemnifications to the purchasers thereof. At September 30, 2008, Colonial's maximum potential amount of future undiscounted payments under these representations, warrants 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 September 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.

Table of Contents

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. Due to counterparty default during the third quarter of 2008, an interest rate swap with a \$210 million notional amount was terminated. At the time of termination, the related derivative had a fair value of approximately \$658,000, and the counterparty also owed the Company approximately \$1.4 million in interest. As it is probable that the Company will not be able to collect these amounts from the counterparty, the fair value of the derivative and the interest receivable were written off. As of September 30, 2008, the fair value of the remaining interest rate swap with a notional amount of \$40 million was a loss of approximately \$443,000. There were no hedging gains or losses resulting from hedge ineffectiveness recognized during the nine months ended September 30, 2008, or September 30, 2007.

The Company has established a collateral agreement with its swap counterparty that provides for exchanges of marketable securities or cash to collateralize either party's net gains above a stated threshold. At September 30, 2008, no outstanding collateral was posted to or received from the swap counterparty.

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 nine months ended September 30, 2008 or September 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 \$42 million at September 30, 2008. The fair value of the origination commitments was a loss of approximately \$119,000 at September 30, 2008, which was more than offset by a gain of approximately \$376,000 on the related sales commitments.

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 September 30, 2008 was \$65.5 million, none of which was designated as a hedge. The fair value of the sales commitments was a gain of approximately \$278,000 at September 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 September 30, 2008 was \$2 billion. The call options are not designated as hedges of the participation interests. The fair value of the call options was a liability of \$15.4 million as of September 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 September 30, 2008.

Table of Contents**Note 10: Short-Term Borrowings**

Short-term borrowings are summarized as follows:

| | September 30, 2008 | December 31, 2007 |
|--------------------------------------|-----------------------|----------------------|
| | (In thousands) | |
| Repurchase agreements (retail) | \$ 458,658 | \$ 568,721 |
| U.S. Treasury term investment option | 300,000 | |
| Total | \$ 758,658 | \$ 568,721 |

Note 11: Long-Term Debt

Long-term debt is summarized as follows:

| | September 30, 2008 | December 31, 2007 |
|---------------------------------------|-----------------------|----------------------|
| | (In thousands) | |
| Variable rate subordinated debentures | \$ | \$ 7,725 |
| Subordinated notes | 610,716 | 378,709 |
| Junior subordinated debt | 108,248 | 108,256 |
| FHLB borrowings | 3,301,236 | 3,513,997 |
| Capital lease obligations | 18,475 | 15,149 |
| Total | \$ 4,038,675 | \$ 4,023,836 |

During the third quarter of 2008, the company repurchased \$9.7 million of its 8% subordinated notes due March 15, 2009.

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.

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.

The par value of long-term debt is scheduled to mature as shown in the table below. This schedule excludes all carrying value adjustments, such as purchase accounting fair value adjustments, hedge accounting fair value adjustments and unamortized premiums and discounts that will not affect future cash payments associated with the maturity of this debt.

| | Parent Only | Consolidated BancGroup |
|------|----------------|---------------------------|
| | (In thousands) | |
| 2008 | \$ | \$ 254 |

Edgar Filing: COLONIAL BANGGROUP INC - Form 10-Q

| | | |
|------------|------------|--------------|
| 2009 | | 43,263 |
| 2010 | | 6,449 |
| 2011 | | 92,819 |
| 2012 | | 2,205 |
| Thereafter | 358,248 | 3,951,840 |
| Total | \$ 358,248 | \$ 4,096,830 |

Table of Contents**Note 12: Employee Benefit Plans****Pension Plan**

BancGroup and 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 make a contribution to the plan in 2008.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In thousands) | | | |
| Components of net periodic benefit income: | | | | |
| Interest cost | \$ 937 | \$ 1,127 | \$ 2,794 | \$ 2,580 |
| Expected return on plan assets | (1,545) | (1,761) | (4,602) | (3,970) |
| Net periodic benefit income | \$ (608) | \$ (634) | \$ (1,808) | \$ (1,390) |

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 September 30, 2008 and 2007 was \$1.3 million and \$447,000, respectively. The related income tax benefit was \$469,000 and \$27,000, respectively. Total compensation cost for stock-based compensation awards for the nine months ended September 30, 2008 and 2007 was \$3.9 million and \$2.4 million, respectively. The related income tax benefit was \$1.4 million and \$472,000, 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 | 1,129,151 | 11.13 |
| Exercised | (50,700) | 12.14 |
| Cancelled | (283,703) | 18.54 |
| Outstanding at September 30, 2008 | 4,372,818 | \$ 17.20 |

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:

| | Nine months ended September 30, 2008 |
|---|---|
| Expected option term | 5.33 years |
| Weighted average expected volatility | 31.63% |
| Weighted average risk-free interest rate | 3.08% |
| 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 | 1,113,505 | 8.45 |
| Vested | (4,670) | 23.75 |
| Cancelled | (34,802) | 14.77 |
| Nonvested at September 30, 2008 | 1,592,199 | \$ 13.07 |

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 September 30, | | | Nine Months Ended September 30, | | |
|--|----------------------------------|---------|---------------------|---------------------------------|---------|---------------------|
| | Net Income (Loss) | Shares | Per Share Amount | Net Income (Loss) | Shares | Per Share Amount |
| (In thousands, except per share amounts) | | | | | | |
| 2008 | | | | | | |
| Basic EPS | \$ (71,210) | 200,757 | \$ (0.35) | \$ (55,369) | 182,216 | \$ (0.30) |
| Effect of dilutive instruments: | | | | | | |
| Options and nonvested restricted stock | | | | | | |
| Diluted EPS | \$ (71,210) | 200,757 | \$ (0.35) | \$ (55,369) | 182,216 | \$ (0.30) |
| 2007 | | | | | | |
| Basic EPS | \$ 69,355 | 153,536 | \$ 0.45 | \$ 171,953 | 153,358 | \$ 1.12 |
| Effect of dilutive instruments: | | | | | | |
| Options and nonvested restricted stock | | 784 | | | 952 | |
| Diluted EPS | \$ 69,355 | 154,320 | \$ 0.45 | \$ 171,953 | 154,310 | \$ 1.11 |

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 5,965,000 for both the three and nine months ended September 30, 2008, respectively, and 1,933,000 and 1,621,000 for the three and nine months ended September 30, 2007, respectively. Because Colonial had a net loss for the three and nine months ended September 30, 2008, diluted EPS does not include the impact of potentially dilutive awards of approximately 395,000 and 289,000, respectively.

Table of Contents

Note 15: Income Taxes

In accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*, BancGroup has recorded a liability for unrecognized tax benefits and the related interest and penalties at September 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) | | | | | | | | |
| Three Months Ended September 30, 2008 | | | | | | | | |
| Net interest income before intersegment income / expense | \$ 63,177 | \$ 58,142 | \$ 8,609 | \$ 12,638 | \$ 10,141 | \$ 21,485 | \$ (7,443) | \$ 166,749 |
| Intersegment interest income / expense | 6,148 | (22,646) | 19,944 | (2,812) | (466) | (5,236) | 5,068 | |
| Net interest income | 69,325 | 35,496 | 28,553 | 9,826 | 9,675 | 16,249 | (2,375) | 166,749 |
| Provision for loan losses | 101,544 | 5,508 | 6,726 | 4,505 | 2,102 | 885 | 38,129 | 159,399 |
| Noninterest income | 19,010 | 3,171 | 12,967 | 7,194 | 2,003 | 1,696 | (401) | 45,640 |
| Noninterest expense | 61,277 | 4,868 | 20,873 | 11,345 | 6,500 | 8,358 | 49,218 | 162,439 |
| Minority interest expense/REIT preferred dividends | | | | | | | 5,336 | 5,336 |
| Income/(loss) before income taxes | \$ (74,486) | \$ 28,291 | \$ 13,921 | \$ 1,170 | \$ 3,076 | \$ 8,702 | \$ (95,459) | (114,785) |
| Income taxes | | | | | | | | (43,575) |
| Net Loss | | | | | | | | \$ (71,210) |
| Total Assets | \$ 11,227,224 | \$ 4,257,680 | \$ 4,217,757 | \$ 1,324,214 | \$ 1,074,615 | \$ 1,725,845 | \$ 2,435,236 | \$ 26,262,571 |
| Total Deposits | \$ 9,804,365 | \$ 640,241 | \$ 4,101,698 | \$ 735,369 | \$ 757,692 | \$ 731,542 | \$ 1,722,026 | \$ 18,492,933 |
| Three Months Ended September 30, 2007 | | | | | | | | |
| Net interest income before intersegment income / expense | \$ 80,531 | \$ 50,636 | \$ 13,789 | \$ 20,121 | \$ 14,903 | \$ 26,405 | \$ (10,374) | \$ 196,011 |
| Intersegment interest income / expense | 1,144 | (28,002) | 19,149 | (8,262) | (2,710) | (11,573) | 30,254 | |
| Net interest income | 81,675 | 22,634 | 32,938 | 11,859 | 12,193 | 14,832 | 19,880 | 196,011 |
| Provision for loan losses | 2,074 | (150) | 7,631 | 446 | 141 | 129 | (5,471) | 4,800 |
| Noninterest income | 18,535 | 6,538 | 12,706 | 2,698 | 1,914 | 1,806 | 8,761 | 52,958 |
| Noninterest expense | 50,372 | 2,585 | 20,052 | 6,094 | 5,775 | 7,686 | 42,387 | 134,951 |
| Minority interest expense/REIT preferred dividends | | | | | | | 5,336 | 5,336 |
| Income/(loss) before income taxes | \$ 47,764 | \$ 26,737 | \$ 17,961 | \$ 8,017 | \$ 8,191 | \$ 8,823 | \$ (13,611) | 103,882 |
| Income taxes | | | | | | | | 34,527 |
| Net Income | | | | | | | | \$ 69,355 |
| Total Assets | \$ 11,403,781 | \$ 3,076,091 | \$ 4,009,515 | \$ 1,413,308 | \$ 1,029,184 | \$ 1,579,079 | \$ 2,033,108 | \$ 24,544,066 |
| Total Deposits | \$ 9,113,148 | \$ 1,250,414 | \$ 3,970,979 | \$ 731,220 | \$ 678,954 | \$ 696,367 | \$ 493,559 | \$ 16,934,641 |

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) | | | | | | | |
| Nine Months Ended September 30, 2008 | | | | | | | | |
| Net interest income before intersegment income / expense | \$ 210,290 | \$ 184,954 | \$ 30,123 | \$ 41,892 | \$ 33,710 | \$ 64,780 | \$ (42,952) | \$ 522,797 |
| Intersegment interest income / expense | 12,850 | (83,023) | 57,440 | (13,001) | (4,965) | (20,574) | 51,273 | |
| Net interest income | 223,140 | 101,931 | 87,563 | 28,891 | 28,745 | 44,206 | 8,321 | 522,797 |
| Provision for loan losses | 180,559 | 5,655 | 15,933 | 13,336 | 10,308 | 1,762 | 46,389 | 273,942 |
| Noninterest income | 55,102 | 8,861 | 39,865 | 19,459 | 5,595 | 4,685 | 25,543 | 159,110 |
| Noninterest expense | 183,554 | 17,581 | 64,495 | 31,595 | 20,118 | 24,546 | 148,695 | 490,584 |
| Minority interest expense/REIT preferred dividends | | | | | | | 16,008 | 16,008 |
| Income/(loss) before income taxes | \$ (85,871) | \$ 87,556 | \$ 47,000 | \$ 3,419 | \$ 3,914 | \$ 22,583 | \$ (177,228) | (98,627) |
| Income taxes | | | | | | | | (43,258) |
| Net Income | | | | | | | | \$ (55,369) |
| Nine Months Ended September 30, 2007 | | | | | | | | |
| Net interest income before intersegment income / expense | \$ 246,597 | \$ 137,316 | \$ 51,525 | \$ 61,354 | \$ 42,500 | \$ 75,376 | \$ (48,495) | \$ 566,173 |
| Intersegment interest income / expense | 1,611 | (77,055) | 51,777 | (23,884) | (6,808) | (32,129) | 86,488 | |
| Net interest income | 248,208 | 60,261 | 103,302 | 37,470 | 35,692 | 43,247 | 37,993 | 566,173 |
| Provision for loan losses | 4,545 | (441) | 12,835 | 2,248 | 185 | 430 | (6,647) | 13,155 |
| Noninterest income | 54,662 | 20,941 | 38,366 | 9,813 | 5,746 | 5,180 | (7,750) | 126,958 |
| Noninterest expense | 153,303 | 6,827 | 61,604 | 17,788 | 18,120 | 22,637 | 134,297 | 414,576 |
| Minority interest expense/REIT preferred dividends | | | | | | | 7,648 | 7,648 |
| Income/(loss) before income taxes | \$ 145,022 | \$ 74,816 | \$ 67,229 | \$ 27,247 | \$ 23,133 | \$ 25,360 | \$ (105,055) | 257,752 |
| Income taxes | | | | | | | | 85,799 |
| Net Income | | | | | | | | \$ 171,953 |

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 \$334 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 an impairment. The Company's annual impairment test was performed at September 30, 2008 with the assistance of the valuation group of an international accounting firm. The goodwill impairment test is a two-step process, which requires management to make judgments in determining the assumptions used in the calculations. The first step involves estimating the fair value of each reporting unit and comparing it to the reporting unit's carrying value, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, then a second step is performed to measure the actual amount of goodwill impairment, if any. The second step initially involves determining the implied fair value of goodwill. This requires the Company to allocate the estimated fair value to all the assets and liabilities of the reporting unit. Any unallocated fair value represents the implied fair value of goodwill which is compared to its corresponding carrying value. If the implied fair value is less than the carrying value, an impairment loss is recognized in an amount equal to that deficit. Management determined that no goodwill impairment charge was required as of September 30, 2008 as the implied value of goodwill for each tested reporting unit exceeded its carrying value.

Fair values of reporting units are estimated using discounted cash flow models derived from internal earnings forecasts. The key assumptions used to estimate the fair value of each reporting unit include earnings forecasts for five years, terminal values based on future growth rates, and discount rates that reflect the range of the Company's market capitalization plus a control premium. 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.

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 \$26.3 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 September 30, 2008, BancGroup's branch network consisted of 344 offices in Florida, Alabama, Georgia, Nevada and Texas.

Colonial reported a net loss of \$71.2 million and \$55.4 million for the three and nine months ended September 30, 2008, respectively, as the Company recorded \$159.4 million and \$273.9 million in provision for loan losses during these same periods. This is compared to net income of \$69.4 million and \$172.0 million for the three and nine months ended September 30, 2007, respectively. Colonial recorded net charge-offs of \$121.4 million and \$227.8 million for the three and nine months ended September 30, 2008, respectively, compared to \$10.4 million and \$20.2 million for the same periods in 2007. The Company reported a loss per share of \$0.35 and \$0.30 for the three and nine months ended September 30, 2008, respectively, compared to earnings per diluted share of \$0.45 and \$1.11 for the same periods in 2007.

The Company's capital ratios remained significantly above the regulatory well capitalized limits at September 30, 2008. The Company's board of directors suspended dividend payments on common stock beginning in the fourth quarter of 2008. The board evaluates the payment of dividends each quarter. The suspension of the dividend will preserve approximately \$77 million per year in capital.

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.

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

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

Table of Contents

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 September 2008. Due to intense competition for deposits from financial services companies, cost of funds in 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.

The Company's net interest income, on a tax equivalent basis, decreased \$29.1 million, or 14.7%, for the three months ended September 30, 2008, as compared to the same period of the prior year. The yield on average earning assets decreased 60 basis points more than the decrease in the rate on average interest bearing liabilities causing net interest margin to contract 80 basis points. The impact to net interest income caused by net interest margin contraction was mitigated by a \$2.0 billion, or 9.4%, 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 nine months ended September 30, 2008, the Company's net interest income, on a tax equivalent basis, decreased \$41.1 million, or 7.2%, as compared to the same period of the prior year. The yield on average earning assets decreased 53 basis points more than the decrease in the rate on average interest bearing liabilities causing net interest margin to contract 70 basis points. The impact to net interest income caused by net interest margin contraction was mitigated by a \$3.2 billion, or a 15.1% 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 a 280 basis point decline in the average Wall Street Journal Prime rate and a 252 basis point decline in the average 1 Month LIBOR rate for the nine months ended September 2008, as compared to the same period of the prior year. For the three and nine months ended September 30, 2008, approximately 63% and 64%, respectively, of Colonial's earning assets were variable,

Table of Contents

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 deposits from financial services companies. The average cost of deposits exceeded the average Federal Funds rate by 53 and 25 basis points, respectively, for the three and nine months ended September 30, 2008, as compared to average deposit costs which were 180 and 185 basis points, respectively, lower than the average Federal Funds rate for the three and nine months ended September 30, 2007. The following table shows average rates for selected balance sheet categories as well as selected market rates.

Analysis of Average Rates

| | Three Months Ended | | Increase/ (Decrease) | Nine Months Ended | | Increase/ (Decrease) |
|---|-----------------------|-------|-------------------------|-----------------------|-------|-------------------------|
| | September 30, 2008 | 2007 | | September 30, 2008 | 2007 | |
| Loans, net of unearned income | 5.93% | 7.69% | (1.76)% | 6.18% | 7.74% | (1.56)% |
| Loans held for sale | 5.08% | 7.17% | (2.09)% | 4.95% | 6.98% | (2.03)% |
| Securities | 5.73% | 5.82% | (0.09)% | 5.85% | 5.56% | 0.29% |
| Resell agreements & other interest earning assets | 4.86% | 6.83% | (1.97)% | 4.94% | 6.79% | (1.85)% |
| Total interest earning assets | 5.71% | 7.32% | (1.61)% | 5.87% | 7.31% | (1.44)% |
| Interest bearing deposits | 3.00% | 4.11% | (1.11)% | 3.19% | 4.11% | (0.92)% |
| Total deposits | 2.53% | 3.38% | (0.85)% | 2.68% | 3.38% | (0.70)% |
| Wholesale borrowings | 4.44% | 5.05% | (0.61)% | 4.31% | 5.20% | (0.89)% |
| Total interest bearing liabilities | 3.33% | 4.34% | (1.01)% | 3.47% | 4.38% | (0.91)% |
| Federal Funds rate | 2.00% | 5.18% | (3.18)% | 2.43% | 5.23% | (2.80)% |
| 1 Month LIBOR | 2.62% | 5.43% | (2.81)% | 2.84% | 5.36% | (2.52)% |
| Wall Street Journal Prime | 5.00% | 8.18% | (3.18)% | 5.43% | 8.23% | (2.80)% |

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 nine months ended September 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 \$2.2 billion, or 9.2%, and \$3.6 billion, or 15.3%, for the three and nine months ended September 30, 2008, respectively, as compared to the same periods of the prior year.

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

| | Three Months Ended September 30, | | | | | |
|--|----------------------------------|-------------------|--------------|-------------------|-------------------|--------------|
| | 2008 | | | 2007 | | |
| | Average Volume | Interest | Rate | Average Volume | Interest | Rate |
| | (Dollars in thousands) | | | | | |
| ASSETS: | | | | | | |
| Loans, net of unearned income(2) | \$ 15,226,350 | \$ 226,684 | 5.93% | \$ 15,312,020 | \$ 296,369 | 7.69% |
| Loans held for sale(2) | 2,235,273 | 28,560 | 5.08% | 1,637,193 | 29,572 | 7.17% |
| Securities(2) | 3,896,374 | 55,797 | 5.73% | 3,087,712 | 44,944 | 5.82% |
| Securities purchased under agreements to resell | 2,123,426 | 26,953 | 5.05% | 1,467,957 | 25,616 | 6.93% |
| Federal funds sold | 114,005 | 509 | 1.77% | 70,406 | 921 | 5.19% |
| Other interest earning assets | 11,870 | 39 | 1.31% | 8,581 | 56 | 2.60% |
| Total interest earning assets(3) | 23,607,298 | \$ 338,542 | 5.71% | 21,583,869 | \$ 397,478 | 7.32% |
| Nonearning assets(2) | 2,472,366 | | | 2,288,847 | | |
| Total assets | \$ 26,079,664 | | | \$ 23,872,716 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | |
| Interest bearing non-time deposits | \$ 5,515,157 | \$ 21,265 | 1.53% | \$ 6,412,818 | \$ 50,106 | 3.10% |
| Time deposits | 8,538,910 | 81,670 | 3.81% | 6,982,656 | 87,791 | 4.99% |
| Brokered time deposits | 1,523,366 | 14,466 | 3.78% | 337,411 | 4,320 | 5.08% |
| Total interest bearing deposits | 15,577,433 | 117,401 | 3.00% | 13,732,885 | 142,217 | 4.11% |
| Repurchase agreements | 509,712 | 2,375 | 1.85% | 562,344 | 5,826 | 4.11% |
| Federal funds purchased | 86,464 | 417 | 1.92% | 501,321 | 6,558 | 5.19% |
| Other short-term borrowings | 45,652 | 257 | 2.24% | 153,804 | 1,916 | 4.94% |
| Long-term debt(2) | 4,040,852 | 49,218 | 4.85% | 3,290,566 | 43,005 | 5.19% |
| Total interest bearing liabilities | 20,260,113 | \$ 169,668 | 3.33% | 18,240,920 | \$ 199,522 | 4.34% |
| Noninterest bearing demand deposits | 2,871,552 | | | 2,949,526 | | |
| Other liabilities(2) | 281,097 | | | 213,124 | | |
| Total liabilities | 23,412,762 | | | 21,403,570 | | |
| Minority interest/REIT preferred securities | 293,058 | | | 293,244 | | |
| Shareholders equity | 2,373,844 | | | 2,175,902 | | |
| Total liabilities and shareholders equity | \$ 26,079,664 | | | \$ 23,872,716 | | |
| RATE DIFFERENTIAL | | | 2.38% | | | 2.98% |
| NET INTEREST INCOME AND NET YIELD ON INTEREST EARNING ASSETS ON A TAX EQUIVALENT BASIS(3) | | \$ 168,874 | 2.85% | | \$ 197,956 | 3.65% |
| Taxable equivalent adjustments(1): | | | | | | |
| Loans | | (199) | | | (247) | |
| Securities | | (1,926) | | | (1,698) | |

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

| | | | | | | |
|---|---------------|------------|-------|---------------|------------|-------|
| Total taxable equivalent adjustments | | (2,125) | | | (1,945) | |
| Net interest income | | \$ 166,749 | | | \$ 196,011 | |
| TOTAL AVERAGE DEPOSITS: | | | | | | |
| Total interest bearing deposits | \$ 15,577,433 | \$ 117,401 | 3.00% | \$ 13,732,885 | \$ 142,217 | 4.11% |
| Noninterest bearing demand deposits | 2,871,552 | | | 2,949,526 | | |
| Total average deposits | \$ 18,448,985 | \$ 117,401 | 2.53% | \$ 16,682,411 | \$ 142,217 | 3.38% |
| Total average deposits, excluding brokered time | \$ 16,925,619 | \$ 102,935 | 2.42% | \$ 16,345,000 | \$ 137,897 | 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)**

| | Three Months Ended September 30, 2008 Change from September 30, 2007 Attributed to(1) | | |
|---|--|----------------------------------|--------------------|
| | Total | Volume (In thousands) | Rate |
| INTEREST INCOME: | | | |
| Loans, net of unearned income | \$ (69,685) | \$ (1,758) | \$ (67,927) |
| Loans held for sale | (1,012) | 7,613 | (8,625) |
| Securities | 10,853 | 11,548 | (695) |
| Securities purchased under agreements to resell | 1,337 | 8,293 | (6,956) |
| Federal funds sold | (412) | 195 | (607) |
| Other interest earning assets | (17) | 11 | (28) |
| Total interest income | (58,936) | 25,902 | (84,838) |
| INTEREST EXPENSE: | | | |
| Interest bearing non-time deposits | (28,841) | (3,464) | (25,377) |
| Time deposits | (6,121) | 14,647 | (20,768) |
| Brokered time deposits | 10,146 | 11,252 | (1,106) |
| Repurchase agreements | (3,451) | (248) | (3,203) |
| Federal funds purchased | (6,141) | (2,009) | (4,132) |
| Other short-term borrowings | (1,659) | (612) | (1,047) |
| Long-term debt | 6,213 | 9,033 | (2,820) |
| Total interest expense | (29,854) | 28,599 | (58,453) |
| Net interest income | \$ (29,082) | \$ (2,697) | \$ (26,385) |

(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 \$58.9 million for the three months ended September 30, 2008, as compared to the same period of the prior year. Average earning assets increased \$2.0 billion while the yield earned on those assets decreased 161 basis points. The drivers of these changes are more fully described in the paragraphs below.

Interest income on loans decreased \$69.7 million for the three months ended September 30, 2008, as compared to the same period of the prior year. The decrease in interest income 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 decreased \$1.0 million for the three months ended September 30, 2008, as compared to the same period of the prior year. The average volume of loans held for sale increased \$598.1 million, or 36.5%, primarily from growth in the Company's mortgage warehouse lending division. The increase in volume was offset by a decrease in the yield on loans held for sale which decreased 209 basis points to 5.08% compared to 7.17% in the same period of the prior year. The yield is driven by the prevailing market rates which were significantly lower in the three months ended September 30, 2008 than in the same period of the prior year.

Interest income on securities increased \$10.9 million for the three months ended September 30, 2008, as compared to the same period of the prior year. The increase was primarily the result of an average volume increase of \$808.7 million, or 26%.

Table of Contents

For the three months ended September 30, 2008, interest income from securities purchased under agreements to resell increased \$1.3 million, as compared to the same period of the prior year. The average volume of securities purchased under agreements to resell increased \$655.5 million, or 44.7%, primarily from growth in the Company's mortgage warehouse division. The yield on securities purchased under agreements to resell decreased 188 basis points to 5.05% compared to 6.93% in the same period of the prior year. The yield is driven by the prevailing market rates which were significantly lower in the three months ended September 30, 2008 than in the same period of the prior year.

Interest expense decreased approximately \$29.9 million for the three months ended September 30, 2008, as compared to the same period of the prior year. The decrease in interest expense was driven primarily by a 101 basis points decrease in the cost of average interest bearing liabilities which was partially offset by a \$2.0 billion, or 11.1%, increase in average interest bearing liabilities. Including the impact of average noninterest bearing deposits, which decreased \$78.0 million, average funding costs decreased 82 basis points to 2.92%. The drivers of the decrease in funding costs are described in the paragraphs below.

For the three months ended September 30, 2008, interest expense on interest bearing non-time deposits decreased \$28.8 million, as compared to the same period of the prior year. The decrease in interest expense was due to a rate reduction of 157 basis points and an average volume decrease of \$897.7 million, or 14.0%.

For the three months ended September 30, 2008, interest expense on time deposits decreased \$6.1 million, as compared to the same period of the prior year. The decrease in interest expense was due to an interest rate decrease of 118 basis points which was partially offset by an average volume increase of \$1.6 billion, or 22.3%. The growth of time deposits is attributable to customer preference for higher rate products and increased competition for deposits as a funding source.

For the three months ended September 30, 2008, interest expense on brokered time deposits increased \$10.1 million, as compared to the same period of the prior year. The increase in interest expense was due to an increase in average volume of \$1.2 billion, or 351.5%, which was partially offset by an interest rate decrease of 130 basis points.

For the three months ended September 30, 2008, interest expense on short-term borrowings, consisting of repurchase agreements, federal funds purchased, and other short-term borrowings, decreased \$11.3 million, as compared to the same period of the prior year. The decrease in interest expense was primarily caused by a decrease in average short-term borrowings of \$575.6 million, or 47.3%, and a rate decrease of 277 basis points.

For the three months ended September 30, 2008, interest expense on long-term debt increased \$6.2 million, as compared to the same period of the prior year. The increase in interest expense was primarily caused by an increase in average long-term debt of \$750.3 million, or 22.8%, partially offset by an interest rate decrease of 34 basis points.

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

| | Nine Months Ended September 30, | | | | | |
|--|---------------------------------|-------------------|--------------|-------------------|-------------------|--------------|
| | 2008 | | | 2007 | | |
| | Average Volume | Interest | Rate | Average Volume | Interest | Rate |
| | (Dollars in thousands) | | | | | |
| ASSETS: | | | | | | |
| Loans, net of unearned income(2) | \$ 15,671,050 | \$ 724,860 | 6.18% | \$ 15,257,881 | \$ 883,076 | 7.74% |
| Loans held for sale(2) | 2,781,151 | 103,018 | 4.95% | 1,603,221 | 83,733 | 6.98% |
| Securities(2) | 3,746,228 | 164,306 | 5.85% | 2,982,418 | 124,387 | 5.56% |
| Securities purchased under agreements to resell | 2,116,299 | 80,026 | 5.05% | 1,280,597 | 66,073 | 6.90% |
| Federal funds sold | 85,955 | 1,762 | 2.74% | 75,259 | 2,956 | 5.25% |
| Other interest earning assets | 13,419 | 109 | 1.09% | 6,048 | 130 | 2.87% |
| Total interest earning assets(3) | 24,414,102 | \$ 1,074,081 | 5.87% | 21,205,424 | \$ 1,160,355 | 7.31% |
| Nonearning assets(2) | 2,498,064 | | | 2,138,957 | | |
| Total assets | \$ 26,912,166 | | | \$ 23,344,381 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | |
| Interest bearing non-time deposits | \$ 6,142,254 | \$ 76,888 | 1.67% | \$ 6,367,451 | \$ 148,251 | 3.11% |
| Time deposits | 8,018,344 | 247,827 | 4.13% | 6,761,111 | 252,538 | 4.99% |
| Brokered time deposits | 1,563,300 | 50,599 | 4.32% | 355,974 | 13,581 | 5.10% |
| Total interest bearing deposits | 15,723,898 | 375,314 | 3.19% | 13,484,536 | 414,370 | 4.11% |
| Repurchase agreements | 525,268 | 8,608 | 2.19% | 611,590 | 19,708 | 4.31% |
| Federal funds purchased | 515,905 | 11,615 | 3.01% | 650,231 | 25,729 | 5.29% |
| Other short-term borrowings | 144,744 | 3,201 | 2.95% | 166,231 | 6,426 | 5.17% |
| Long-term debt(2) | 4,067,025 | 146,159 | 4.80% | 3,084,463 | 123,881 | 5.37% |
| Total interest bearing liabilities | 20,976,840 | \$ 544,897 | 3.47% | 17,997,051 | \$ 590,114 | 4.38% |
| Noninterest bearing demand deposits | 3,001,553 | | | 2,889,110 | | |
| Other liabilities(2) | 285,375 | | | 180,669 | | |
| Total liabilities | 24,263,768 | | | 21,066,830 | | |
| Minority interest/REIT preferred securities | 293,058 | | | 140,627 | | |
| Shareholders equity | 2,355,340 | | | 2,136,924 | | |
| Total liabilities and shareholders equity | \$ 26,912,166 | | | \$ 23,344,381 | | |
| RATE DIFFERENTIAL | | | 2.40% | | | 2.93% |
| NET INTEREST INCOME AND NET YIELD ON INTEREST EARNING ASSETS ON A TAX EQUIVALENT BASIS(3) | | \$ 529,184 | 2.89% | | \$ 570,241 | 3.59% |
| Taxable equivalent adjustments(1): | | | | | | |
| Loans | | (555) | | | (626) | |
| Securities | | (5,832) | | | (3,442) | |

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

| | | | | | | |
|---|----|------------|----|---------|---------|--------------------------------|
| Total taxable equivalent adjustments | | (6,387) | | | (4,068) | |
| Net interest income | \$ | 522,797 | | | \$ | 566,173 |
| TOTAL AVERAGE DEPOSITS: | | | | | | |
| Total interest bearing deposits | \$ | 15,723,898 | \$ | 375,314 | 3.19% | \$ 13,484,536 \$ 414,370 4.11% |
| Noninterest bearing demand deposits | | 3,001,553 | | | | 2,889,110 |
| Total average deposits | \$ | 18,725,451 | \$ | 375,314 | 2.68% | \$ 16,373,646 \$ 414,370 3.38% |
| Total average deposits, excluding brokered time | \$ | 17,162,151 | \$ | 324,715 | 2.53% | \$ 16,017,672 \$ 400,789 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

| | Nine Months Ended September 30, 2008 Change from September 30, 2007 Attributed to(1) | | |
|---|---|----------------------------------|--------------------|
| | Total | Volume (In thousands) | Rate |
| INTEREST INCOME: | | | |
| Loans, net of unearned income | \$ (158,216) | \$ 19,812 | \$ (178,028) |
| Loans held for sale | 19,285 | 43,627 | (24,342) |
| Securities | 39,919 | 33,432 | 6,487 |
| Securities purchased under agreements to resell | 13,953 | 31,673 | (17,720) |
| Federal funds sold | (1,194) | 219 | (1,413) |
| Other interest earning assets | (21) | 60 | (81) |
| Total interest income | (86,274) | 128,823 | (215,097) |
| INTEREST EXPENSE: | | | |
| Interest bearing non-time deposits | (71,363) | (2,783) | (68,580) |
| Time deposits | (4,711) | 38,779 | (43,490) |
| Brokered time deposits | 37,018 | 39,095 | (2,077) |
| Repurchase agreements | (11,100) | (1,402) | (9,698) |
| Federal funds purchased | (14,114) | (3,026) | (11,088) |
| Other short-term borrowings | (3,225) | (465) | (2,760) |
| Long-term debt | 22,278 | 35,428 | (13,150) |
| Total interest expense | (45,217) | 105,626 | (150,843) |
| Net interest income | \$ (41,057) | \$ 23,197 | \$ (64,254) |

(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 \$86.3 million for the nine months ended September 30, 2008, as compared to the same period of the prior year. Average earning assets increased \$3.2 billion while the yield earned on those assets decreased 144 basis points. The drivers of these changes are more fully described in the paragraphs below.

Interest income on loans decreased \$158.2 million for the nine months ended September 30, 2008, 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 156 basis points, partially offset by a \$413.2 million, or 2.7%, increase in average loans.

Interest income on loans held for sale increased \$19.3 million for the nine months ended September 30, 2008, as compared to the same period of the prior year. The average volume of loans held for sale increased \$1.2 billion, or 73.5%, primarily from growth in the Company's mortgage warehouse division. The increase in volume was partially offset by a decrease in the yield on loans held for sale which decreased 203 basis points to 4.95% from 6.98% in the same period of the prior year. The yield is driven by the prevailing market rates which were significantly lower in the nine months ended September 30, 2008 than in the same period of the prior year.

Interest income on securities increased \$39.9 million for the nine months ended September 30, 2008, as compared to the same period of the prior year. The increase was primarily the result of a \$763.8 million, or 25.6%, increase in average volume as well as a 29 basis point increase in yield on the average balances.

For the nine months ended September 30, 2008, interest income from securities purchased under agreements to resell increased \$14.0 million, as compared to the same period of the prior year. The average volume of securities purchased under agreements to resell increased \$835.7 million, or 65.3%, primarily from growth in the Company's mortgage warehouse division. The yield on securities purchased under agreements to resell decreased

Table of Contents

185 basis points to 5.05% from 6.90% in the same period of the prior year. The yield is driven by the prevailing market rates which were significantly lower in the nine months ended September 30, 2008 than in the same period of the prior year.

Interest expense decreased approximately \$45.2 million for the nine months ended September 30, 2008, as compared to the same period of the prior year. The decrease in interest expense was driven primarily by a 91 basis points decrease in the cost of average interest bearing liabilities which was partially offset by a \$3.0 billion, or 16.6%, increase in average interest bearing liabilities. Including the impact of average noninterest bearing deposits, which increased \$112.4 million, average funding costs decreased 74 basis points to 3.04%. The drivers of the decrease in funding costs are described in the paragraphs below.

For the nine months ended September 30, 2008, interest expense on interest bearing non-time deposits decreased \$71.4 million, as compared to the same period of the prior year. The decrease in interest expense was due to a rate reduction of 144 basis points and an average volume decrease of \$225.2 million, or 3.5%.

For the nine months ended September 30, 2008, interest expense on time deposits decreased \$4.7 million, as compared to the same period of the prior year. The decrease in interest expense was due to an interest rate decrease of 86 basis points which was partially offset by an average volume increase of \$1.3 billion, or 18.6%. The growth of time deposits is attributable to customer preference for higher rate products and increased competition for deposits as a funding source.

For the nine months ended September 30, 2008, interest expense on brokered time deposits increased \$37.0 million, as compared to the same period of the prior year. The increase in interest expense was due to an increase in average volume of \$1.2 billion, or 339.2%, which was partially offset by an interest rate decrease of 78 basis points.

For the nine months ended September 30, 2008, interest expense on short-term borrowings decreased \$28.4 million, as compared to the same period of the prior year. The decrease in interest expense was primarily due to an interest rate decrease of 222 basis points and an average volume decrease of \$242.1 million, or 17.0%.

For the nine months ended September 30, 2008, interest expense on long-term debt increased \$22.3 million, as compared to the same period of the prior year. The increase in interest expense was primarily caused by an increase in average long-term debt of \$982.6 million, or 31.9%, partially offset by an interest rate decrease of 57 basis points.

Loan Loss Provision

The real estate markets in the U.S. have deteriorated at an accelerating 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 nine months ended September 30, 2008 was \$159.4 million and \$273.9 million, respectively, compared to \$4.8 million and \$13.2 million for the same periods in 2007. Net charge-offs for the three and nine months ended September 30, 2008 were \$121.4 million and \$227.8 million, or an annualized 3.17% and 1.94% as a percentage of average loans, respectively, compared to \$10.4 million and \$20.2 million, or an annualized 0.27% and 0.18% as a percentage of average loans, respectively, for the same periods in 2007. BancGroup's allowance for loan losses was 1.88% of period end net loans at September 30, 2008 compared to 1.50% at December 31, 2007 and 1.14% at September 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 nine months ended September 30, 2008, as compared to the same periods of the prior year. Core noninterest income declined approximately \$1.3 million, or 2.4%, and increased \$4.0 million, or 2.6%, for the three and nine months ended September 30, 2008, respectively, as compared to the same periods of the prior year.

| | Three Months Ended | | Increase (decrease) | | Nine Months Ended | | Increase (decrease) | |
|--|------------------------|-----------|---------------------|----------|--------------------|------------|---------------------|----------|
| | September 30, 2008 | 2007 | \$ | % | September 30, 2008 | 2007 | \$ | % |
| | (Dollars in thousands) | | | | | | | |
| Service charges on deposit accounts | \$ 19,645 | \$ 19,376 | \$ 269 | 1.4 % | \$ 58,132 | \$ 55,749 | \$ 2,383 | 4.3 % |
| Electronic banking | 5,149 | 4,923 | 226 | 4.6 % | 15,428 | 13,972 | 1,456 | 10.4 % |
| Other retail banking fees | 2,209 | 2,794 | (585) | (20.9)% | 7,297 | 9,661 | (2,364) | (24.5)% |
| Retail banking fees | 27,003 | 27,093 | (90) | (0.3)% | 80,857 | 79,382 | 1,475 | 1.9 % |
| Mortgage banking origination and sales | 8,095 | 3,236 | 4,859 | 150.2 % | 22,808 | 10,083 | 12,725 | 126.2 % |
| Wealth management services | 4,370 | 4,506 | (136) | (3.0)% | 14,243 | 12,611 | 1,632 | 12.9 % |
| Mortgage warehouse fees | 1,467 | 5,936 | (4,469) | (75.3)% | 3,713 | 19,223 | (15,510) | (80.7)% |
| Bank-owned life insurance | 4,720 | 5,070 | (350) | (6.9)% | 15,009 | 15,027 | (18) | (0.1)% |
| Other income | 6,042 | 7,117 | (1,075) | (15.1)% | 19,437 | 15,791 | 3,646 | 23.1 % |
| Core noninterest income | 51,697 | 52,958 | (1,261) | (2.4)% | 156,067 | 152,117 | 3,950 | 2.6 % |
| Securities and derivatives gains (losses), net | (6,057) | | (6,057) | (100.0)% | 3,043 | 2,097 | 946 | 45.1 % |
| 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)% |
| Total noninterest income | \$ 45,640 | \$ 52,958 | \$ (7,318) | (13.8)% | \$ 159,110 | \$ 126,958 | \$ 32,152 | 25.3 % |

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 nine months ended September 30, 2008, as compared to the same periods of the prior year, primarily due to an increase in the number of customer accounts as well as customers maintaining lower balances in those 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 nine months ended September 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 nine months ended September 30, 2008, as compared to the same periods of the prior year, primarily due to lower official check commissions due to a decrease in rate. In addition, the decline for the nine months ended September 30, 2008, as compared to the same period of the

Table of Contents

prior year, also included a decline in merchant services revenue due to the Company's sale of its merchant services contracts in April 2007 and the subsequent 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 59% and 49% for the three and nine months ended September 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.

Wealth management services include discount brokerage, investment sales, asset management, trust services and insurance sales including term, universal, whole life and long-term care. Wealth management services revenue declined for the three months ended September 30, 2008, as compared to the same period of the prior year, primarily due to variable annuity sales, securities commissions, and insurance commissions partially offset by an increase in fixed annuity sales. Wealth management services revenue increased for the nine months ended September 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, insurance 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 nine months ended September 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 decreased for the three and nine months ended September 30, 2008, as compared to the same periods of the prior year, primarily due to lower crediting rates.

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 September 30, 2008, as compared to the same period of the prior year, was primarily the result of a \$1.9 million decline in revenue from joint ventures and a \$3.3 million decline in gains related to the sale of bank premises and equipment partially offset by a \$1.5 million increase in the favorable fair value adjustment on retail mortgage forward sale commitments and a \$1.4 million increase in income from an equity investment. The increase for the nine months ended September 30, 2008, as compared to the same period of the prior year, was primarily the result of an increase in revenue of \$2.6 million from gains related to the sale of bank premises, a \$2.1 million gain on the sale of Visa, Inc. stock from the initial public offering, a \$1.5 million increase in income from an equity investment, and a \$2.0 million increase in servicing income partially offset by a decline of \$5.7 million in joint venture revenue.

The Company's decision to buy and sell securities is based primarily on its management of interest rate risk. During 2008, the Company recorded gains of \$6.1 million in the first quarter from the sale of approximately \$217 million in securities, a \$3.0 million gain in the second quarter from the early termination of a \$250 million resell agreement, and losses of \$4.9 million on the sale of Wachovia stock and \$658,000 on an interest rate swap due to the bankruptcy of the counterparty in the third quarter. 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

Table of Contents

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.

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 third quarter of 2008, compared to the same period in 2007. Core noninterest expense increased \$28.5 million, or 21.3%, and \$78.1 million, or 19.5%, for the three and nine months ended September 30, 2008, respectively, as compared to the same periods in 2007. Annualized core noninterest expense to average assets was 2.49% and 2.38% for the three and nine months ended September 30, 2008, respectively, as compared to 2.24% and 2.29% for the three and nine months ended September 30, 2007, respectively.

| | Three Months Ended | | Increase | | Nine Months Ended | | Increase | |
|--|------------------------|-------------------|------------------|--------------|-----------------------|-------------------|------------------|--------------|
| | September 30, 2008 | 2007 | \$ | % | September 30, 2008 | 2007 | \$ | % |
| | (Dollars in thousands) | | | | | | | |
| Salaries and employee benefits | \$ 75,129 | \$ 68,345 | \$ 6,784 | 9.9% | \$ 223,557 | \$ 208,155 | \$ 15,402 | 7.4% |
| Occupancy expense of bank premises, net | 24,177 | 19,634 | 4,543 | 23.1 | 71,296 | 56,861 | 14,435 | 25.4 |
| Furniture and equipment expenses | 15,215 | 13,226 | 1,989 | 15.0 | 45,052 | 39,698 | 5,354 | 13.5 |
| Professional services | 7,252 | 4,967 | 2,285 | 46.0 | 20,697 | 13,695 | 7,002 | 51.1 |
| FDIC insurance and other regulatory fees | 4,169 | 1,727 | 2,442 | 141.4 | 13,145 | 4,173 | 8,972 | 215.0 |
| Amortization of intangible assets | 4,154 | 3,500 | 654 | 18.7 | 12,459 | 9,752 | 2,707 | 27.8 |
| Electronic banking and other retail banking expenses | 3,479 | 5,766 | (2,287) | (39.7) | 11,772 | 15,485 | (3,713) | (24.0) |
| Loan and other real estate related costs | 4,550 | 1,170 | 3,380 | 288.8 | 11,685 | 2,407 | 9,278 | 385.5 |
| Communications | 2,799 | 2,677 | 122 | 4.6 | 8,481 | 8,568 | (87) | (1.0) |
| Advertising | 3,440 | 1,570 | 1,870 | 119.1 | 8,427 | 7,468 | 959 | 12.8 |
| Postage and courier | 2,373 | 2,589 | (216) | (8.3) | 7,265 | 7,920 | (655) | (8.3) |
| Loss on equity investments | 4,995 | 660 | 4,335 | 656.8 | 9,462 | 1,585 | 7,877 | 497.0 |
| Travel | 1,572 | 1,586 | (14) | (0.9) | 4,533 | 5,275 | (742) | (14.1) |
| Other expenses | 8,851 | 6,281 | 2,570 | 40.9 | 31,640 | 20,283 | 11,357 | 56.0 |
| Core noninterest expense | \$ 162,155 | \$ 133,698 | \$ 28,457 | 21.3 | \$ 479,471 | \$ 401,325 | \$ 78,146 | 19.5 |
| Severance expense | | 500 | (500) | (100.0) | 786 | 4,045 | (3,259) | (80.6) |
| Merger related expenses | | 753 | (753) | (100.0) | | 2,298 | (2,298) | (100.0) |
| Net losses related to the early extinguishment of debt | 284 | | 284 | 100.0 | 10,327 | 6,908 | 3,419 | 49.5 |
| Total noninterest expense | \$ 162,439 | \$ 134,951 | \$ 27,488 | 20.4% | \$ 490,584 | \$ 414,576 | \$ 76,008 | 18.3% |

Table of Contents

Salaries and benefits increased for both the three and nine months ended September 30, 2008, as compared to the same periods of the prior year. The change was primarily due to increases in commissions, an annual salary increase effective at the beginning of March, an increase in the Company's number of full-time equivalent employees, and related benefits. The total number of full-time equivalent employees increased in both the three and nine months ended September 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. Both periods also included one more working day than the same periods in 2007.

The increases in occupancy and furniture and equipment expenses for both the three and nine months ended September 30, 2008, as compared to the same periods of the prior year, were primarily the result of acquisitions of Commercial Bankshares, Inc. and Citrus and 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 leasebacks is offset by the amortization of deferred gains on sales, which is included noninterest income.

Professional services increased for the three and nine months ended September 30, 2008, as compared to the same periods in 2007, primarily due to increases in technology related services, higher legal fees associated with lending activities, and accounting fees for work related to the valuation of certain mortgage warehouse assets.

FDIC insurance and other regulatory fees were higher for the three and nine months ended September 30, 2008, as compared to the same period 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 late 2007.

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

Total electronic banking and other retail banking expenses decreased for both the three and nine months ended September 30, 2008, as compared to the same periods of the prior year. The decrease for both the three and nine months ended September 30, 2008, was primarily due to a \$772,000 and \$1.6 million decrease in fraud losses and an \$803,000 and \$2 million decrease in consulting expenses, respectively.

The increase in loan and other real estate related costs for the three and nine months ended September 30, 2008, as compared to the same period of the prior year were driven by higher expenses related to the current real estate environment.

Advertising expense increased for the three and nine months ended September 30, 2008, as compared to the same periods in 2007, primarily due to increased newspaper and radio ads associated with Colonial's Image Campaign.

Postage and courier expenses decreased for both the three and nine months ended September 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 nine months ended September 30, 2008, as compared to the same period of the prior year due to a \$3.5 million loss reserve established related to real estate joint ventures and low income housing tax credit investments, as well as an impairment recognized on certain equity investments.

Travel expenses decreased for both the three and nine months ended September 30, 2008, as compared to the same period in 2007, due to increased focus on reducing travel and entertainment expenses.

Table of Contents

Other expenses increased for both the three and nine months ended September 30, 2008, as compared to the same periods of the prior year. For the three months ended September 30, 2008, the increase was primarily due to a \$1.3 million increase in the off balance sheet credit reserve. For the nine months ended September 30, 2008, the increase in other expenses was primarily due to a \$6.9 million increase in subservicing fees associated with the increased balances of mortgage warehouse assets, an increase in the off balance sheet credit reserve of \$1.8 million and numerous operational expenses that have increased in conjunction with an increase in the number of branches. Also included in the nine months ended September, 30, 2008 is a net fair value loss related to the lower of cost or fair value adjustment on mortgage loans held for sale, the fair value adjustment on mortgage loans held for sale for which BancGroup has elected the fair value option and the call options the Company sells in relation to these loans totaling \$1.6 million.

Severance expense relates primarily to the reduction in force efforts in 2007. This expense decreased significantly for the nine months ended September 30, 2008.

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. During the third quarter, a \$283,000 loss was incurred on the early termination of \$47.5 million in brokered CD s.

Provision (Benefit) for Income Taxes

BancGroup s provision (benefit) for income taxes was based on an approximate 43.9% and 33.3% estimated effective tax rate for the nine months ended September 30, 2008 and 2007, respectively. The effective tax rate in the first nine months of 2008 differs 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 (loss). The provision (benefit) for income taxes for the nine months ended September 30, 2008 and 2007 was (\$43.3) million and \$85.8 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 September 30, 2008 are as follows:

| | September 30, 2008 | December 31, 2007 | Increase (Decrease) | |
|---|------------------------|----------------------|---------------------|--------|
| | | | \$ | % |
| | (Dollars in thousands) | | | |
| Cash and due from banks | \$ 1,328,493 | \$ 474,948 | \$ 853,545 | 179.7% |
| Securities purchased under agreements to resell | 1,493,585 | 2,049,664 | (556,079) | (27.1) |
| Securities | 3,825,523 | 3,682,510 | 143,013 | 3.9 |
| Loans held for sale | 2,060,709 | 1,544,222 | 516,487 | 33.4 |
| Loans, net of unearned income | 15,168,356 | 15,923,178 | (754,822) | (4.7) |
| Goodwill | 1,007,053 | 1,008,168 | (1,115) | (0.1) |
| Other real estate owned | 134,893 | 15,760 | 119,133 | 755.9 |
| Total assets | 26,262,571 | 25,975,989 | 286,582 | 1.1 |
| Non-time deposits | 8,076,740 | 9,771,573 | (1,694,833) | (17.3) |
| Total deposits | 18,492,933 | 18,544,267 | (51,334) | (0.3) |
| Short-term borrowings | 758,658 | 568,721 | 189,937 | 33.4 |
| Long-term debt | 4,038,675 | 4,023,836 | 14,839 | 0.4 |
| Shareholders' equity | 2,388,957 | 2,273,571 | 115,386 | 5.1 |
| Cash and Due From Banks | | | | |

In response to significant uncertainty in the marketplace at September 30, 2008, and to increase liquid assets, Colonial increased the level of cash balances maintained at the Federal Reserve, thereby increasing Cash and Due From Banks by \$854 million to \$1.3 billion as of September 30, 2008.

Securities Purchased Under Agreements to Resell

Colonial's securities purchased under agreements to resell at September 30, 2008 represent mortgage backed securities which have been securitized by customers of the Company's mortgage warehouse lending division and are under agreements to be sold to third-party investors. Colonial purchases these securities prior to their initial settlements with those investors. Refer to the *Mortgage Warehouse Assets* section of Management's Discussion and Analysis for additional information. At December 31, 2007, Colonial had an additional \$500 million invested in traditional resell agreements that were terminated in the first nine months of 2008 which caused the decline in the balance.

Table of Contents**Securities**

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

| | Carrying Value at September 30, 2008 | Carrying Value at December 31, 2007 |
|---|---|--|
| | (In thousands) | |
| Securities available for sale: | | |
| Agency mortgage-backed securities | \$ 1,554,428 | \$ 1,359,503 |
| Non-agency mortgage-backed securities | 1,544,091 | 1,701,047 |
| Obligations of state and political subdivisions | 345,385 | 371,930 |
| Corporate notes | | 6,819 |
| Federal Reserve and FHLB stock and other | 175,605 | 241,983 |
| Total securities available for sale | 3,619,509 | 3,681,282 |
| Held to maturity securities: | | |
| U.S. Treasury securities | 500 | 500 |
| Agency mortgage-backed securities | 205,280 | 495 |
| Obligations of state and political subdivisions | 234 | 233 |
| Total held to maturity securities | 206,014 | 1,228 |
| Total securities | \$ 3,825,523 | \$ 3,682,510 |

Securities by Credit Rating at September 30, 2008

| | Government/ Agency Obligations | Standard & Poor's or Equivalent Designation | | | Other | Total |
|---|-----------------------------------|--|-------------------|-----------------|-------------------|---------------------|
| | | AAA | A-to AA+ | Unrated | | |
| (In thousands) | | | | | | |
| U.S. Treasury securities | \$ 500 | \$ | \$ | \$ | \$ | \$ 500 |
| Agency mortgage-backed securities | 1,759,708 | | | | | 1,759,708 |
| Non-agency mortgage-backed securities | | 1,204,043 | 249,572 | | 90,476 | 1,544,091 |
| Obligations of state and political subdivisions | | 154,564 | 187,866 | 1,315 | 1,874 | 345,619 |
| Federal Reserve and FHLB stock and other | | | | | 175,605 | 175,605 |
| Total securities | \$ 1,760,208 | \$ 1,358,607 | \$ 437,438 | \$ 1,315 | \$ 267,955 | \$ 3,825,523 |

Securities by Credit Rating at December 31, 2007

| | Government/ Agency Obligations | Standard & Poor's or Equivalent Designation | | | Other | Total |
|---|--------------------------------------|--|----------|---------|---------|-----------|
| | | AAA | A-to AA+ | Unrated | | |
| (In thousands) | | | | | | |
| U.S. Treasury securities | \$ 500 | \$ | \$ | \$ | \$ | \$ 500 |
| Agency mortgage-backed securities | 1,359,998 | | | | | 1,359,998 |
| Non-agency mortgage-backed securities | | 1,701,047 | | | | 1,701,047 |
| 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 |

Edgar Filing: COLONIAL BANGROUP INC - Form 10-Q

| | | | | | | |
|------------------|--------------|--------------|----------|----------|------------|--------------|
| Total securities | \$ 1,360,498 | \$ 2,069,095 | \$ 7,286 | \$ 1,794 | \$ 243,837 | \$ 3,682,510 |
|------------------|--------------|--------------|----------|----------|------------|--------------|

Table of Contents

During the third quarter of 2008, the Company sold approximately \$5 million in securities and purchased approximately \$315 million in new securities, excluding transactions in Federal Home Loan Bank of Atlanta (FHLB) Stock. During the third quarter of 2008, one of the rating agencies downgraded approximately \$90.5 million of non-agency mortgage-backed securities that had previously been rated AAA to less than A-. Colonial reviews all non-agency mortgage-backed securities at least quarterly and does not expect to lose any principal or interest on its holdings.

During the second quarter of 2008, the Company did not sell any securities but did purchase approximately \$128 million in new securities, excluding transactions in 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.

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:

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| | (In thousands) | |
| Securities purchased under agreements to resell | \$ 1,493,585 | \$ 1,549,664 |
| Loans held for sale | 1,986,088 | 1,484,502 |
| Mortgage warehouse loans | 653,398 | 290,603 |
| Total on balance sheet | 4,133,071 | 3,324,769 |
| Interests sold | | |
| Loans held for sale | | 769,221 |
| Mortgage warehouse loans | | 230,779 |
| Total under management | \$ 4,133,071 | \$ 4,324,769 |

Table of Contents**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 September 30, 2008 increased \$516 million, or 33.5%, 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:

| | September 30, 2008 | December 31, 2007 |
|---|-------------------------|----------------------|
| | (In thousands) | |
| Short-term participations in mortgage loans held for sale (includes \$1,873,985 measured at fair value at September 30, 2008) | \$ 1,986,088 | \$ 1,484,502 |
| Retail mortgage loans held for sale | 72,239 | 59,720 |
| Other loans held for sale | 2,382 | |
| Total loans held for sale | \$ 2,060,709 | \$ 1,544,222 |

During the third quarter of 2008, BancGroup elected the fair value option for its short-term participations in mortgage loans held for sale acquired on or after August 1, 2008. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. For a detailed discussion of the determination of fair value for individual financial instruments, see Note 4, *Fair Value Measurements*.

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 \$1.1 billion, or 7.2%, from December 31, 2007 to September 30, 2008. Loans in the mortgage warehouse division increased \$362.8 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.

Gross Loan Portfolio

Table of Contents

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

| | September 30, 2008 | December 31, 2007 |
|--|--------------------|-------------------|
| | (In thousands) | |
| Commercial, financial and agricultural | \$ 1,675,774 | \$ 1,506,986 |
| Commercial real estate | 5,001,780 | 5,012,773 |
| Real estate construction | 5,448,351 | 6,296,262 |
| Residential real estate | 2,587,610 | 2,673,823 |
| Consumer and other | 471,160 | 452,642 |
| Total loans | 15,184,675 | 15,942,486 |
| Less: unearned income | (16,319) | (19,308) |
| Total loans, net of unearned income | \$ 15,168,356 | \$ 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 33.2% of the commercial real estate loan portfolio, at September 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.

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.

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 nine months of 2008, BancGroup continued to finalize the purchase accounting for acquisitions, thereby resulting in a \$3 million increase in goodwill in the second quarter and a \$1 million reduction in the third quarter. BancGroup tests goodwill for impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. The Company's annual impairment test was performed at September 30, 2008 with the assistance of the valuation group of an international accounting firm. The goodwill impairment test is a two-step process, which requires management to make judgments in determining the assumptions used in the calculations. The first step involves estimating the fair value of each reporting unit and comparing it to the reporting unit's carrying value, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, then a second step is performed to measure the actual amount of goodwill impairment, if any. The second step initially involves determining the implied fair value of goodwill. This requires the Company to allocate the estimated fair value to all the assets and liabilities of the reporting unit. Any unallocated fair value represents the implied fair value of goodwill which is compared to its corresponding carrying value. If the implied fair value is less than the carrying value, an impairment loss is

Table of Contents

recognized in an amount equal to that deficit. Management determined that no goodwill impairment charge was required as of September 30, 2008 as the implied value of goodwill for each tested reporting unit exceeded its carrying value.

Fair values of reporting units are estimated using discounted cash flow models derived from internal earnings forecasts. The key assumptions used to estimate the fair value of each reporting unit include earnings forecasts for five years, terminal values based on future growth rates, and discount rates that reflect the range of the Company's market capitalization plus a control premium. 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.

Other Real Estate Owned

Total other real estate owned increased \$119.1 million from December 31, 2007 to September 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 waterfront locations in Florida and coastal Alabama.

Deposits

Total deposits decreased \$51 million, or 0.3%, from December 31, 2007 to September 30, 2008. The decrease was driven by transaction accounts which decreased \$1.7 billion, or 17.3%, over that same time period. This decrease was substantially offset by an increase in time deposits of \$1.6 billion, or 18.7%. Refer to the *Liquidity and Funding* section of Management's Discussion and Analysis for further information.

Wholesale Borrowings

Wholesale borrowings are comprised of short-term borrowings and long-term debt. Short-term borrowings consist of repurchase agreements, federal funds purchased and U.S. Treasury term investment options. Short-term borrowings increased \$189.9 million, or 33%, from December 31, 2007 to September 30, 2008 as Colonial purchased \$300 million in U.S. Treasury term investment options and decreased repurchase agreements by \$110 million, or 19%. Long-term debt consists of FHLB advances, subordinated debt, junior subordinated debt, and capital lease obligations. Total long-term debt increased \$14.8 million, or 0.37%, from December 31, 2007 to September 30, 2008. During the period from December 31, 2007 to September 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 \$19.8 million of fixed rate subordinated debt. Refer to Notes 10 and 11, *Short-Term Borrowings* and *Long-Term Debt*, respectively, 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 seeks to maintain 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

Table of Contents

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 32.9% and 35.9% of total loans as of September 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 12.4% 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 an 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 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 help to 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 33.2% of the total commercial real estate portfolio outstanding at September 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.

Table of Contents

The following charts reflect the geographic diversity and property type distribution of total construction and commercial real estate loans at September 30, 2008:

| | Construction | % of Total (Dollars in thousands) | Commercial Real Estate | % of Total |
|---|---------------------|--------------------------------------|------------------------|---------------|
| Average Loan Size | \$ 1,119 | | \$ 737 | |
| Weighted Average Loan to Value | 71.1% | | 64.4% | |
| Geographic Diversity (by property location)(1) | | | | |
| Florida | \$ 2,499,727 | 45.9% | \$ 3,076,404 | 61.5% |
| Alabama | 526,103 | 9.6% | 588,363 | 11.8% |
| Georgia | 591,530 | 10.9% | 320,846 | 6.4% |
| Texas | 901,816 | 16.5% | 436,436 | 8.7% |
| Nevada | 504,366 | 9.3% | 213,164 | 4.3% |
| Other | 424,809 | 7.8% | 366,567 | 7.3% |
| Total | \$ 5,448,351 | 100.0% | \$ 5,001,780 | 100.0% |

| | Property Type Distribution % | | | Property Type Distribution % | |
|---------------------------------------|------------------------------|-----------------|-------------------------------------|----------------------------------|-----------------|
| | Construction Portfolio | Total Portfolio | | Commercial Real Estate Portfolio | Total Portfolio |
| Residential Construction | | | Retail | 22.3% | 7.4% |
| Residential development and lots | 25.9% | 9.3% | Office | 21.8% | 7.2% |
| Residential home construction | 10.9% | 3.9% | Warehouse | 14.4% | 4.7% |
| Residential land | 7.6% | 2.7% | Multi-Family | 9.1% | 3.0% |
| Condominium | 5.4% | 2.0% | Healthcare | 8.4% | 2.8% |
| Total Residential Construction | 49.8% | 17.9% | Lodging | 6.2% | 2.0% |
| Commercial Construction | | | Church or School | 3.7% | 1.2% |
| Commercial land | 17.4% | 6.2% | Industrial | 2.5% | 0.8% |
| Commercial development and lots | 11.1% | 4.0% | Farm | 2.4% | 0.8% |
| Retail | 6.8% | 2.5% | Other(2) | 9.2% | 3.0% |
| Multi-Family | 3.9% | 1.4% | Total Commercial Real Estate | 100.0% | 32.9% |
| Office | 3.7% | 1.3% | | | |
| Other(2) | 7.3% | 2.6% | | | |
| Total Commercial Construction | 50.2% | 18.0% | | | |
| Total Construction | 100.0% | 35.9% | | | |

(1) No more than 12.4% 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**

| | Construction | Commercial Real Estate |
|--|---------------------|-----------------------------------|
| 75 Largest Loans Total (in thousands) | \$ 1,324,644 | \$ 938,131 |
| % of 75 Largest Loans to Category Total | 24.3% | 18.8% |
| Average Loan to Value Ratio (75 largest loans) | 70.8% | 68.5% |
| Average Debt Coverage Ratio (75 largest loans) | N/A | 1.46 |

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 principals involved 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 75.7% at September 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 \$326.7 million, at September 30, 2008:

Residential Construction Loans

| | Total Outstanding | | Residential Development | Builder Lot Inventory | Consumer- Owned Lots | Residential Presold | Residential Speculative | Land | Condominium Construction |
|--------------|------------------------------|-------------|------------------------------------|--------------------------------------|---------------------------------|--------------------------------|------------------------------------|---------------|-------------------------------------|
| | Amount | % | | | | | | | |
| | (Dollars in millions) | | | | | | | | |
| Florida | \$ 1,102 | 46% | \$ 406 | \$ 57 | \$ 75 | \$ 60 | \$ 143 | \$ 178 | \$ 183 |
| Texas | 476 | 20 | 289 | 29 | 5 | 10 | 44 | 84 | 15 |
| Georgia | 329 | 14 | 168 | 19 | 1 | 18 | 82 | 20 | 21 |
| Alabama | 292 | 12 | 93 | 38 | 27 | 25 | 86 | 16 | 7 |
| Nevada | 145 | 6 | 49 | 1 | 2 | 23 | 20 | 50 | |
| Other | 43 | 2 | 10 | 1 | 1 | 2 | 4 | 12 | 13 |
| Total | \$ 2,387 | 100% | \$ 1,015 | \$ 145 | \$ 111 | \$ 138 | \$ 379 | \$ 360 | \$ 239 |

Table of Contents

Residential Construction Loans

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 73.0% at September 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).

Table of Contents

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 September 30, 2008 and 2007:

| | Nine Months Ended | |
|--|-----------------------|-----------------------|
| | September 30, 2008 | September 30, 2007 |
| | (In thousands) | |
| Balance, January 1 | \$ 238,845 | \$ 174,850 |
| Addition due to acquisition | | 7,147 |
| Provision charged to income | 273,942 | 13,155 |
| Reduction due to sale of mortgage loans originally held for investment | | (2,303) |
| Loans charged off | (231,878) | (26,520) |
| Recoveries | 4,091 | 6,349 |
| Balance, September 30 | \$ 285,000 | \$ 172,678 |

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

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| (Dollars in thousands) | | | | |
| Charge-offs: | | | | |
| Commercial, financial and agricultural | \$ 17,960 | \$ 519 | \$ 22,411 | \$ 2,921 |
| Commercial real estate | 4,762 | 1,917 | 12,687 | 2,785 |
| Real estate construction | 86,809 | 8,217 | 173,763 | 15,193 |
| Residential real estate | 6,904 | 2,200 | 12,944 | 2,751 |
| Consumer and other | 6,252 | 891 | 10,073 | 2,870 |
| Total charge-offs | 122,687 | 13,744 | 231,878 | 26,520 |
| Recoveries: | | | | |
| Commercial, financial, agricultural | 364 | 2,779 | 1,227 | 4,157 |
| Commercial real estate | 27 | 24 | 234 | 61 |
| Real estate construction | 431 | 6 | 799 | 47 |
| Residential real estate | 96 | 134 | 403 | 504 |
| Consumer and other | 361 | 405 | 1,428 | 1,580 |
| Total recoveries | 1,279 | 3,348 | 4,091 | 6,349 |
| Net charge-offs: | | | | |
| Commercial, financial, agricultural | 17,596 | (2,260) | 21,184 | (1,236) |
| Commercial real estate | 4,735 | 1,893 | 12,453 | 2,724 |
| Real estate construction | 86,378 | 8,211 | 172,964 | 15,146 |
| Residential real estate | 6,808 | 2,066 | 12,541 | 2,247 |
| Consumer and other | 5,891 | 486 | 8,645 | 1,290 |
| Total net charge-offs | \$ 121,408 | \$ 10,396 | \$ 227,787 | \$ 20,171 |
| Percent of net charge-offs to average loan category (annualized basis): | | | | |
| Commercial, financial, agricultural | 4.39% | (0.65)% | 1.75% | (0.12)% |
| Commercial real estate | 0.38% | 0.17% | 0.33% | 0.08% |
| Real estate construction | 6.11% | 0.51% | 3.88% | 0.32% |
| Residential real estate | 1.04% | 0.30% | 0.64% | 0.11% |
| Consumer and other | 5.36% | 0.40% | 2.52% | 0.35% |
| Total | 3.17% | 0.27% | 1.94% | 0.18% |

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.

| | September 30, 2008 | December 31, 2007 |
|---|------------------------|----------------------|
| | (Dollars in thousands) | |
| Nonaccrual loans: | | |
| Commercial, financial and agricultural | \$ 6,018 | \$ 2,467 |
| Commercial real estate | 57,155 | 6,374 |
| Real estate construction | 436,352 | 96,397 |
| Residential real estate | 42,125 | 15,993 |
| Consumer and other | 1,135 | 655 |
| Total nonaccrual loans* | 542,785 | 121,886 |
| Other real estate owned and repossessions | 134,951 | 15,760 |
| Total nonperforming assets* | \$ 677,736 | \$ 137,646 |
| Allowance as a percent of nonperforming assets* | 42% | 174% |
| Aggregate loans contractually past due 90 days or more for which interest is still accruing | \$ 42,454 | \$ 23,837 |
| Net charge-offs quarter-to-date | \$ 121,408 | \$ 33,895 |
| Net charge-offs year-to-date | \$ 227,787 | \$ 54,066 |
| Total nonperforming assets* as a percent of loans, other real estate and repossessions | 4.43% | 0.86% |
| Allowance as a percent of loans | 1.88% | 1.50% |
| Allowance as a percent of nonperforming loans* | 53% | 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 \$502.4 million and \$105.4 million at September 30, 2008, and December 31, 2007 respectively. The related allowance for loan losses on impaired loans was \$65.4 million at September 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 \$685.4 million of potential problem loans identified at September 30, 2008 compared to \$491.5 million at June 30, 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

Table of Contents

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.

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.

The following table represents the output from the Company's simulation model based on the balance sheet at September 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

Table of Contents

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.

| Basis Points Change | Fed Funds Rate | | Percentage Change in 12 Month Projected Net Interest Income Versus Projected Net Interest Income Under No Rate Change(1) | |
|---------------------|-----------------------|----------------------|---|----------------------|
| | September 30, 2008 | December 31, 2007 | September 30, 2008 | December 31, 2007 |
| +200 | 4.00 | 6.25 | 1.1% | 3.0% |
| +100 | 3.00 | 5.25 | 2.8% | 2.1% |
| No rate change | 2.00 | 4.25 | | |
| -100 | 1.00 | 3.25 | (4.7)% | (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 more asset sensitive from December 31, 2007. The change of sensitivity on the asset side was created by an increase in the proportion of variable rate assets from December, 2007 to September, 2008. In addition, on the liability side there has been a shift from non-term transaction accounts to time deposits, there was a shift from variable FHLB and long-term debt to fixed due to FHLB advances converting to fixed rate, and the termination of a received fixed swap on \$210 million of subordinated debt. Another key factor contributing to the increase in asset sensitivity in down rates is lower beta assumptions due to the inability to reprice non-term deposits down due to competition and current market strategy.

On each of October 8, 2008 and October 29, 2008, the Federal Reserve lowered the Federal Funds rate target level by 50 basis points, bringing the target Federal Funds rate to 1.00%.

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 78% of the Company's total funding sources and fund 70% of the Company's total assets at September 30, 2008. Total average deposits for the nine months ended September 30, 2008 increased \$2.4 billion, or 14.4%, over the same period of the prior year. Excluding brokered time deposits, total average deposits for the nine months ended September 30, 2008 increased \$1.1 billion, or 7.2%, 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 September 30, 2008 and December 31, 2007, the Company 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, U.S. Treasury term investment options 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.

During October 2008, Colonial secured \$700 million of funding through the Federal Reserve's Term Auction Facility (TAF) at a rate of 1.39% that matures in January 2009. This funding was utilized to further enhance Colonial's liquidity.

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:

| | September 30, 2008 | December 31, 2007 |
|---|------------------------|----------------------|
| | (Dollars in thousands) | |
| Risk-Based Capital: | | |
| Shareholders' equity | \$ 2,388,957 | \$ 2,273,571 |
| Unrealized losses on securities available-for-sale | 106,391 | 3,673 |
| Net impact of cash flow hedges and actuarial gains | (2,428) | 741 |
| Qualifying minority interests in consolidated subsidiaries | 294,020 | 293,812 |
| Qualifying trust preferred securities | 105,000 | 105,000 |
| Intangible assets (net of allowed deferred taxes) | (1,044,138) | (1,053,822) |
| Other adjustments | (1,531) | (3,304) |
| Tier I Capital | 1,846,271 | 1,619,671 |
| Allowable loan loss and unfunded commitment reserves | 231,425 | 239,845 |
| Subordinated debt | 539,247 | 310,805 |
| 45% of net unrealized gains on equity securities available-for-sale | 13 | |
| Tier II Capital | 770,685 | 550,650 |
| Total Capital | \$ 2,616,956 | \$ 2,170,321 |
| Risk-Adjusted Assets | \$ 18,457,673 | \$ 19,715,951 |
| Quarterly Average Assets (for regulatory purposes) | \$ 25,341,050 | \$ 24,266,011 |
| Tier I Leverage Ratio | 7.29% | 6.67% |
| Risk-Adjusted Capital Ratios: | | |
| Tier I Capital Ratio | 10.00% | 8.22% |
| Total Capital Ratio | 14.18% | 11.01% |
| 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 \$334 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.

FAIR VALUE MEASUREMENT

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. A portion of BancGroup's assets and liabilities are measured at fair value on a recurring basis, including securities available for sale, loans held for sale for which BancGroup has elected the fair value option, and derivative assets and liabilities. 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. In the absence of quoted market prices, management determines the fair value of BancGroup's assets and liabilities using models which are based on management's judgment, assumptions and estimates regarding credit quality, liquidity, interest rates and other relevant inputs. The Company's adoption of SFAS 157 and the process used in determining fair values is more fully described in Note 1, *Accounting Policies and Basis of Presentation*, and Note 4, *Fair Value Measurements*.

Table of Contents

At September 30, 2008, \$5.3 billion, or 20.3%, of BancGroup's total assets were measured at fair value on a recurring basis. Approximately 71.0% of these assets were classified as Level 1 or Level 2 within the fair value hierarchy. At September 30, 2008, \$16 million, or 0.1%, of BancGroup's total liabilities were measured at fair value on a recurring basis. Approximately 2.8% of these liabilities were classified as Level 1 or Level 2 within the fair value hierarchy.

At September 30, 2008, \$419 million, or 1.6%, of BancGroup's total assets were measured at fair value on a nonrecurring basis. Approximately 19.8% of these assets were classified as Level 1 or Level 2. At September 30, 2008, there were no liabilities measured at fair value on a nonrecurring basis.

Level 3 assets measured at fair value on a recurring basis were 29.0% of total assets measured at fair value and 5.9% of total assets at September 30, 2008. Level 3 liabilities measured at fair value on a recurring basis were 97.2% of total liabilities measured at fair value and 0.1% of total liabilities at September 30, 2008.

Level 3 assets and liabilities measured at fair value on a recurring basis as of September 30, 2008 include the following: 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 which were transferred into Level 3 during the second quarter of 2008 due to the significance of unobservable inputs (such as the probability of funding) to the overall value of these instruments; and, the Company's non-agency mortgage-backed securities which were transferred into Level 3 in the third quarter of 2008. The transfer of these securities available for sale into Level 3 was based on a significant reduction in market liquidity for these securities. For further discussion on Level 3 instruments, see Note 4, *Fair Value Measurements*.

Imprecision in estimating unobservable market inputs can impact the amount of income or loss recorded for a particular fair value measurement. Furthermore, while BancGroup believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. For a detailed discussion of the determination of fair value for individual financial instruments, see Note 4, *Fair Value Measurements*.

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 September 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 the provisions for loan losses may be necessary if material adverse changes in general economic conditions occur

Table of Contents

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.

Current market volatility and industry developments may adversely affect our business and financial results

The volatility in the capital and credit markets along with the housing declines during the last year have resulted in significant pressure on the financial services industry. We have experienced a higher level of foreclosures and higher losses upon foreclosure than we have historically. If current volatility and market conditions continue or worsen, there can be no assurance that our industry, results of operations or our business will not be significantly adversely impacted. We may have further increases in loan losses, deterioration of capital or limitations on our access to funding or capital, if needed.

Further, if other financial institutions fail to be adequately capitalized or funded, it may negatively impact our business and financial results. We routinely interact with numerous financial institutions in the ordinary course of business and are therefore exposed to operational and credit risk to those institutions. Failures of such institutions may significantly adversely impact our operations.

The impact of the Emergency Economic Stabilization Act of 2008 (EESA) may not stabilize the financial services industry

The EESA was signed into law on October 3, 2008. The legislation is intended to alleviate the financial crisis affecting the U.S. banking system. A number of programs are being developed and implemented under EESA. The EESA may not have the intended effect and therefore the condition of the financial services industry may worsen instead of improving. The failure of the EESA to improve the condition of the U.S. banking system could significantly adversely impact our business, our financial condition, our financial results, our access to funding or capital as well as the trading price of our common stock or other instruments.

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

Item 4. Submission of Matters to a Vote of Security Holders N/A

Item 5. Other Information N/A

Table of Contents

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 6th day of November, 2008.

THE COLONIAL BANCGROUP, INC.

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

Chief Financial Officer