

FIRST CITIZENS BANCSHARES INC /DE/

Form 10-Q

November 07, 2006

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

Washington, D.C. 20549

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**FORM 10-Q**

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**x**    **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
          **For the quarterly period ended September 30, 2006**

or

**..**    **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
          **Commission File Number: 0-16471**

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**First Citizens BancShares, Inc**

(Exact name of Registrant as specified in its charter)

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

**56-1528994**  
(I.R.S. Employer  
Identification Number)

**4300 Six Forks Road, Raleigh, North Carolina**  
(Address of principle executive offices)

**27608**  
(Zip code)

**(919) 716-7000**

(Registrant's telephone number, including area code)

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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 twelve months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days. Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Class A Common Stock \$1 Par Value 8,756,778 shares

Class B Common Stock \$1 Par Value 1,677,675 shares

(Number of shares outstanding, by class, as of November 7, 2006)

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## PART I

## Item 1. Financial Statements (Unaudited)

## Consolidated Balance Sheets

## First Citizens BancShares, Inc. and Subsidiaries

(thousands, except share data)	September 30* 2006	December 31# 2005	September 30* 2005
<b>Assets</b>			
Cash and due from banks	\$ 909,702	\$ 777,928	\$ 702,837
Overnight investments	571,080	481,012	764,756
Investment securities available for sale	2,830,810	2,293,020	2,174,803
Investment securities held to maturity	287,215	636,496	696,928
Loans and leases	10,129,423	9,642,994	9,359,540
Less allowance for loan and lease losses	131,652	128,847	126,297
Net loans	9,997,771	9,514,147	9,233,243
Premises and equipment	679,822	639,469	624,423
Income earned not collected	63,733	54,879	53,918
Other assets	289,110	242,441	234,011
<b>Total assets</b>	<b>\$ 15,629,243</b>	<b>\$ 14,639,392</b>	<b>\$ 14,484,919</b>
<b>Liabilities</b>			
Deposits:			
Noninterest-bearing	\$ 2,724,938	\$ 2,616,177	\$ 2,685,555
Interest-bearing	9,956,212	9,557,681	9,437,936
Total deposits	12,681,150	12,173,858	12,123,491
Short-term borrowings	1,129,510	779,028	696,865
Long-term obligations	424,351	408,987	409,742
Other liabilities	121,978	96,460	95,936
Total liabilities	14,356,989	13,458,333	13,326,034
<b>Shareholders Equity</b>			
Common stock:			
Class A - \$1 par value (8,756,778 shares issued during all periods)	8,757	8,757	8,757
Class B - \$1 par value (1,677,675 shares issued during all periods)	1,678	1,678	1,678
Surplus	143,766	143,766	143,766
Retained earnings	1,113,693	1,029,005	1,004,038
Accumulated other comprehensive income (loss)	4,360	(2,147)	646
<b>Total shareholders equity</b>	<b>1,272,254</b>	<b>1,181,059</b>	<b>1,158,885</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 15,629,243</b>	<b>\$ 14,639,392</b>	<b>\$ 14,484,919</b>

\* Unaudited

# Derived from the 2005 Annual Report on Form 10-K.

See accompanying Notes to Consolidated Financial Statements.



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## Consolidated Statements of Income

## First Citizens BancShares, Inc. and Subsidiaries

(thousands, except per share data; unaudited)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Interest income</b>				
Loans	\$ 175,279	\$ 146,009	\$ 501,658	\$ 417,745
Investment securities:				
U. S. Government	29,615	21,031	80,484	49,621
State, county and municipal	57	61	177	191
Dividends	846	746	2,460	1,495
<b>Total investment securities interest and dividend income</b>	<b>30,518</b>	<b>21,838</b>	<b>83,121</b>	<b>51,307</b>
Overnight investments	8,853	5,687	22,371	12,933
<b>Total interest income</b>	<b>214,650</b>	<b>173,534</b>	<b>607,150</b>	<b>481,985</b>
<b>Interest expense</b>				
Deposits	75,990	47,476	199,599	123,322
Short-term borrowings	11,801	4,373	27,970	8,984
Long-term obligations	8,982	7,457	24,953	19,114
<b>Total interest expense</b>	<b>96,773</b>	<b>59,306</b>	<b>252,522</b>	<b>151,420</b>
<b>Net interest income</b>	<b>117,877</b>	<b>114,228</b>	<b>354,628</b>	<b>330,565</b>
Provision for credit losses	3,813	7,211	13,523	19,531
<b>Net interest income after provision for credit losses</b>	<b>114,064</b>	<b>107,017</b>	<b>341,105</b>	<b>311,034</b>
<b>Noninterest income</b>				
Cardholder and merchant services income	23,146	20,120	63,877	55,612
Service charges on deposit accounts	18,025	19,553	54,491	57,929
Commission income	8,497	6,669	24,708	19,503
Fees from processing services	7,522	6,335	22,003	18,851
Trust and asset management fees	5,203	4,680	15,556	13,966
Mortgage income	2,521	2,507	5,675	6,326
ATM income	1,530	1,985	5,229	6,020
Other service charges and fees	3,999	4,375	11,992	12,479
Securities losses	(120)		(659)	(22)
Other	2,282	1,882	5,091	7,231
<b>Total noninterest income</b>	<b>72,605</b>	<b>68,106</b>	<b>207,963</b>	<b>197,895</b>
<b>Noninterest expense</b>				
Salaries and wages	59,333	55,659	173,022	159,923
Employee benefits	11,034	13,805	38,863	39,461
Occupancy expense	13,353	12,100	38,617	34,986
Equipment expense	13,300	12,388	39,055	37,417
Other	37,845	34,713	112,227	102,174
<b>Total noninterest expense</b>	<b>134,865</b>	<b>128,665</b>	<b>401,784</b>	<b>373,961</b>
<b>Income before income taxes</b>	<b>51,804</b>	<b>46,458</b>	<b>147,284</b>	<b>134,968</b>
Income taxes	18,877	16,505	53,988	49,942
<b>Net income</b>	<b>\$ 32,927</b>	<b>\$ 29,953</b>	<b>\$ 93,296</b>	<b>\$ 85,026</b>

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**Other comprehensive income (loss) net of taxes**

Unrealized securities gains (losses) arising during period	\$ 14,978	\$ (2,440)	\$ 7,308	\$ (3,855)
Unrealized loss on interest rate swap arising during period	(1,434)		(1,200)	
Less: reclassification adjustment for gains (losses) included in net income	(73)		(399)	(13)
Other comprehensive income (loss)	13,617	(2,440)	6,507	(3,842)
Comprehensive income	\$ 46,544	\$ 27,513	\$ 99,803	\$ 81,184
Average shares outstanding	10,434,453	10,434,453	10,434,453	10,434,453
Net income per share	\$ 3.16	\$ 2.87	\$ 8.94	\$ 8.15

See accompanying Notes to Consolidated Financial Statements.

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## Consolidated Statements of Changes in Shareholders' Equity

First Citizens BancShares, Inc. and Subsidiaries

(thousands, except share data, unaudited)	Class A Common Stock	Class B Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balance at December 31, 2004	\$ 8,757	\$ 1,678	\$ 143,766	\$ 927,621	\$ 4,488	\$ 1,086,310
Comprehensive income:						
Net income				85,026		85,026
Unrealized securities losses, net of deferred taxes					(3,842)	(3,842)
Comprehensive income				85,026	(3,842)	81,184
Cash dividends				(8,609)		(8,609)
Balance at September 30, 2005	\$ 8,757	\$ 1,678	\$ 143,766	\$ 1,004,038	\$ 646	\$ 1,158,885
Balance at December 31, 2005	\$ 8,757	\$ 1,678	\$ 143,766	\$ 1,029,005	\$ (2,147)	\$ 1,181,059
Comprehensive income:						
Net income				93,296		93,296
Unrealized securities gains, net of deferred taxes					7,707	7,707
Change in unrecognized loss on cash flow hedge, net of deferred taxes					(1,200)	(1,200)
Comprehensive income				93,296	6,507	99,803
Cash dividends				(8,608)		(8,608)
Balance at September 30, 2006	\$ 8,757	\$ 1,678	\$ 143,766	\$ 1,113,693	\$ 4,360	\$ 1,272,254

See accompanying Notes to Consolidated Financial Statements.



**Table of Contents****Consolidated Statements of Cash Flows**

First Citizens BancShares, Inc. and Subsidiaries

	<b>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(thousands; unaudited)</b>	
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 93,296	\$ 85,026
Adjustments to reconcile net income to cash provided by operating activities:		
Amortization of intangibles	1,745	1,867
Provision for credit losses	13,523	19,531
Deferred tax expense (benefit)	1,329	(6,757)
Change in current taxes payable	6,184	2,634
Depreciation	35,810	33,610
Change in accrued interest payable	14,965	4,415
Change in income earned not collected	(8,854)	(13,344)
Securities losses	659	22
Origination of loans held for sale	(330,315)	(371,164)
Proceeds from sale of loans	355,835	602,722
Gain on sale of loans	(619)	(4,885)
Gain on sale of branch office	(826)	
Net amortization of premiums and discounts	(3,899)	(438)
Net change in other assets	(54,716)	11,821
Net change in other liabilities	3,498	(7,624)
<b>Net cash provided by operating activities</b>	<b>127,615</b>	<b>357,436</b>
<b>INVESTING ACTIVITIES</b>		
Net change in loans outstanding	(522,413)	(247,373)
Purchases of investment securities held to maturity	(26,074)	(262,680)
Purchases of investment securities available for sale	(857,977)	(1,263,839)
Proceeds from maturities of investment securities held to maturity	379,254	443,669
Proceeds from maturities of investment securities available for sale	332,208	330,401
Net change in overnight investments	(90,068)	(381,013)
Dispositions of premises and equipment	5,700	4,506
Additions to premises and equipment	(82,104)	(92,401)
Purchase and sale of branches, net of cash transferred	(19,450)	18,343
<b>Net cash used in investing activities</b>	<b>(880,924)</b>	<b>(1,450,387)</b>
<b>FINANCING ACTIVITIES</b>		
Net change in time deposits	592,780	430,164
Net change in demand and other interest-bearing deposits	(64,935)	321,572
Net change in short-term borrowings	247,289	247,978
Originations of long-term obligations	118,557	125,000
Cash dividends paid	(8,608)	(8,609)
<b>Net cash provided by financing activities</b>	<b>885,083</b>	<b>1,116,105</b>
Change in cash and due from banks	131,774	23,154
Cash and due from banks at beginning of period	777,928	679,683
<b>Cash and due from banks at end of period</b>	<b>\$ 909,702</b>	<b>\$ 702,837</b>

**CASH PAYMENTS FOR:**

Interest	\$ 267,487	\$ 147,005
Income taxes	45,743	52,780

**SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:**

Unrealized securities gains (losses)	\$ 12,680	\$ (6,658)
Unrealized loss on interest rate swap	(1,981)	

See accompanying Notes to Consolidated Financial Statements.

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### **Notes to Consolidated Financial Statements**

(Dollars in thousands, except per share amounts)

#### **Note A**

##### **Accounting Policies**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements.

In the opinion of management, the consolidated financial statements contain all material adjustments necessary to present fairly the financial position of First Citizens BancShares, Inc. as of and for each of the periods presented, and all such adjustments are of a normal recurring nature. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the 2005 First Citizens BancShares, Inc. Annual Report, which is incorporated by reference on Form 10-K. Certain amounts for prior periods have been reclassified to conform with statement presentations for 2006. However, the reclassifications have no effect on shareholders' equity or net income as previously reported.

#### **Note B**

##### **Operating Segments**

BancShares conducts its banking operations through its two wholly-owned subsidiaries, First-Citizens Bank & Trust Company (FCB) and IronStone Bank (ISB). Although FCB and ISB offer similar products and services to customers, each entity operates in distinct geographic markets and each entity operates under a separate charter. Additionally, the financial results and trends of ISB reflect the de novo nature of its growth.

FCB is a mature banking institution that operates from a single charter from its branch network in North Carolina, Virginia, West Virginia, Maryland and Tennessee. ISB began operations in 1997 and currently operates in Georgia, Florida, Texas, Arizona, California, New Mexico, Colorado, Oregon and Washington under a federal thrift charter.

In the aggregate, FCB and its consolidated subsidiaries, which are integral to its branch operation, and ISB account for more than 90 percent of consolidated assets, revenues and net income. Other includes activities of the parent company, Neuse, Incorporated, a subsidiary that owns real property used in the banking operation and American Guaranty Insurance Corporation, a property insurance company.

The adjustments in the accompanying tables represent the elimination of the impact of certain inter-company transactions. The adjustments to interest income and interest expense neutralize the earnings and cost of inter-company borrowings. The adjustments to noninterest income and noninterest expense reflect the elimination of management fees and other services fees paid by one company to another within BancShares consolidated group.

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	As of and for the nine months ended September 30, 2006					
	ISB	FCB	Other	Total	Adjustments	Consolidated
Interest income	\$ 91,558	\$ 514,131	\$ 21,618	\$ 627,307	\$ (20,157)	\$ 607,150
Interest expense	41,557	192,460	38,662	272,679	(20,157)	252,522
Net interest income	50,001	321,671	(17,044)	354,628		354,628
Provision for credit losses	2,366	11,157		13,523		13,523
Net interest income after provision for credit losses	47,635	310,514	(17,044)	341,105		341,105
Noninterest income	8,264	205,102	868	214,234	(6,271)	207,963
Noninterest expense	54,425	352,072	1,558	408,055	(6,271)	401,784
Income (loss) before income taxes	1,474	163,544	(17,734)	147,284		147,284
Income taxes	820	59,347	(6,179)	53,988		53,988
Net income (loss)	\$ 654	\$ 104,197	\$ (11,555)	\$ 93,296	\$	\$ 93,296
Total assets	\$ 2,055,508	\$ 13,432,282	\$ 2,286,128	\$ 17,773,918	\$ (2,144,675)	\$ 15,629,243
Loans and leases	1,821,736	8,307,687		10,129,423		10,129,423
Allowance for loan and lease losses	21,568	110,084		131,652		131,652
Total deposits	1,651,460	11,199,431		12,850,891	(169,741)	12,681,150
	As of and for the nine months ended September 30, 2005					
	ISB	FCB	Other	Total	Adjustments	Consolidated
Interest income	\$ 70,353	\$ 411,076	\$ 6,858	\$ 488,287	\$ (6,302)	\$ 481,985
Interest expense	25,528	111,010	21,184	157,722	(6,302)	151,420
Net interest income	44,825	300,066	(14,326)	330,565		330,565
Provision for credit losses	6,637	12,894		19,531		19,531
Net interest income after provision for credit losses	38,188	287,172	(14,326)	311,034		311,034
Noninterest income	5,454	196,842	1,117	203,413	(5,518)	197,895
Noninterest expense	48,402	329,408	1,669	379,479	(5,518)	373,961
Income (loss) before income taxes	(4,760)	154,606	(14,878)	134,968		134,968
Income taxes	(1,496)	56,600	(5,162)	49,942		49,942
Net income (loss)	\$ (3,264)	\$ 98,006	\$ (9,716)	\$ 85,026	\$	\$ 85,026
Total assets	\$ 1,772,822	\$ 12,590,284	\$ 1,834,162	\$ 16,197,268	\$ (1,712,349)	\$ 14,484,919
Loans and leases	1,590,285	7,769,255		9,359,540		9,359,540
Allowance for loan and lease losses	18,193	108,104		126,297		126,297
Total deposits	1,416,287	10,767,104		12,183,391	(59,900)	12,123,491

**Table of Contents****Note C****Employee Benefits**

BancShares recognized pension expense totaling \$9,142 and \$11,205, respectively, in the nine-month periods ended September 30, 2006 and 2005. Pension expense is included as a component of employee benefit expense.

	<b>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b><u>Components of Net Periodic Benefit Cost</u></b>		
Service cost	\$ 11,569	\$ 10,240
Interest cost	13,328	12,185
Expected return on plan assets	(18,289)	(14,084)
Amortization of prior service cost	185	290
Recognized net actuarial loss	2,349	2,574
<b>Net periodic benefit cost</b>	<b>\$ 9,142</b>	<b>\$ 11,205</b>

The expected long-term rate of return on plan assets for 2006 and 2005 is 8.50 percent.

**Note D****Derivative Financial Instruments**

During the second quarter of 2006, BancShares entered into an interest rate swap that synthetically converts the variable interest rate on long-term borrowings issued in 2006 to a fixed rate. The interest rate swap is a derivative financial instrument that qualifies as a cash flow hedge under Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* (Statement 133). The initial assessment required under Statement 133 concluded that there was no ineffectiveness for this interest rate swap, and there was no fair value at the inception of the swap.

At September 30, 2006, the interest rate swap, which has a notional amount of \$115,000, had an estimated fair value of (\$1,981). Based on the effectiveness test performed as of September 30, 2006, the swap was determined to be effective, and the change in the fair value was recorded as a component of other comprehensive income net of income taxes.

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

#### **INTRODUCTION**

Management's discussion and analysis of earnings and related financial data are presented to assist in understanding the financial condition and results of operations of First Citizens BancShares, Inc. and Subsidiaries (BancShares). BancShares is a financial holding company with two wholly-owned banking subsidiaries: First-Citizens Bank & Trust Company (FCB), a North Carolina-chartered bank, and IronStone Bank (ISB), a federally-chartered thrift institution. FCB operates branches in North Carolina, Virginia, Tennessee, Maryland and West Virginia. ISB operates offices in Georgia, Florida, Texas, New Mexico, Arizona, California, Oregon, Washington and Colorado.

This discussion and analysis should be read in conjunction with the unaudited Consolidated Financial Statements and related notes presented within this report. Intercompany accounts and transactions have been eliminated. Although certain amounts for prior years have been reclassified to conform to statement presentations for 2006, the reclassifications have no effect on shareholders' equity or net income as previously reported.

#### **SUMMARY**

BancShares' earnings and cash flows are derived primarily from the commercial banking activities conducted by its banking subsidiaries. These activities include commercial and consumer lending, deposit and cash management products, cardholder, merchant, wealth management services as well as various other products and services typically offered by commercial banks. FCB and ISB gather interest-bearing and noninterest-bearing deposits from retail and commercial customers. BancShares and its subsidiaries also secure supplemental short-term and long-term funding through various non-deposit sources. We invest the liquidity generated from these funding sources in various types of interest-earning assets such as loans and leases, investment securities and overnight investments. We also invest in bank premises, furniture and equipment used in the subsidiaries' commercial banking business.

External factors influence customer demand for our loan, lease and deposit products. The general strength of the economy influences loan and lease demand as well as the quality and collectibility of our loan and lease portfolio. External economic indicators such as consumer bankruptcy rates and business debt service capacity closely follow trends in the economic cycle. In an effort to stimulate and control the rate of growth of economic activity, monetary actions by the Federal Reserve are significant to the interest rate environment in which we operate. At any point in time, both the existing level and anticipated movement of interest rates have a profound impact on customer demand for our products, our pricing of those products and on our profitability.

Financial institutions frequently focus their strategic and operating emphasis on maximizing profitability and therefore measure their relative success by reference to profitability measures such as return on average assets or return on average shareholders' equity. BancShares' profitability measures have historically compared unfavorably to the returns of similar-sized financial holding companies. We have historically placed significant emphasis upon asset quality, balance sheet liquidity and capital conservation, even when those priorities may be detrimental to short-term profitability.

Based on our organization's strengths, competitive position and strategic focus within the financial services industry, we believe opportunities for significant growth and expansion exist. We operate in diverse and growing geographic markets and believe that through focused strategic emphasis, competitive products and superior customer service, we can increase our business volumes and profitability. In recent years, we have concentrated our efforts on customers who own their own businesses, medical and other professionals and individuals who are financially active. We seek to increase fee income in areas such as merchant processing, working capital finance, insurance, cash management, wealth management and private banking services. We also focus on opportunities to generate income by providing various processing services to other banks.

We attempt to mitigate certain of the risks that can endanger our profitability and growth prospects. While we are attentive to all areas of risk, economic risk is especially problematic due to the lack of control and the likelihood of a material impact on our financial results. Specific economic risks include recession, rapid movements in interest rates, changes in the yield curve and significant shifts in inflation expectations. Compared to our larger competitors, our relatively small asset size and limited capital resources create a level of economic risk that requires constant and focused management attention.

Detailed information regarding the components of net income and other key financial data over the most recent five quarters is provided in Table 1. Tables 4 and 5 provide information on net interest income. Table 6 provides information related to asset quality.

**Net income.** BancShares realized an increase in earnings during the third quarter of 2006 compared to the third quarter of 2005. Consolidated net income during the third quarter of 2006 equaled \$32.9 million, compared to \$30.0 million earned during the corresponding period of 2005. The \$3.0 million or 9.9 percent increase resulted from improved levels of net interest income and noninterest income and lower provision for credit

losses, partially offset by higher noninterest

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expense. Net income per share during the third quarter of 2006 totaled \$3.16, compared to \$2.87 during the third quarter of 2005, a 10.1 percent increase. Return on average assets amounted to 0.84 percent for the third quarter of 2006, unchanged from the same period of 2005. Return on average equity for the third quarter of 2006 equaled 10.45 percent compared to 10.39 percent during the third quarter of 2005.

For the first nine months of 2006, BancShares recorded net income of \$93.3 million, compared to \$85.0 million earned during the first nine months of 2005. The \$8.3 million or 9.7 percent increase was also the result of improved net interest income, higher noninterest income as well as lower provision for credit losses. These favorable variances were partially offset by higher noninterest expense. Net income per share for the first nine months of 2006 was \$8.94, compared to \$8.15 recorded during the same period of 2005. BancShares returned 0.83 percent on average assets during both the first nine months of 2006 and 2005. The annualized return on average equity amounted to 10.23 percent for the first nine months of 2006 compared to 10.16 percent during the same period of 2005.

FCB's net income amounted to \$104.2 million for the nine month period ended September 30, 2006, a 6.3 percent increase from the comparable period of 2005. Higher revenues more than offset the unfavorable impact of increased noninterest expenses.

ISB reported a net income of \$654,000 during the first nine months of 2006, compared to a net loss of \$3.3 million during the same period of 2005. Improved earnings for ISB have resulted from the favorable impact of loan growth, higher working capital finance fees and merchant income as well as lower provision for credit losses. Partially offsetting the favorable impact of these trends is a declining net yield on interest-earning assets resulting from the adverse impact of the flat yield curve. Due to added costs arising from anticipated franchise expansion and the pressure resulting from the flat yield curve, ISB's profitability will likely remain low.

Shareholders' equity. BancShares continues to exceed minimum regulatory capital standards, and the banking subsidiaries remain well-capitalized. During the past several years, the de novo growth of ISB has required the infusion of significant amounts of capital by BancShares to support its rapidly expanding balance sheet. BancShares infused \$25.0 million into ISB during the first nine months of 2006. Since ISB was chartered in 1997, BancShares has provided \$275.0 million in capital. Losses incurred since ISB's inception total \$28.6 million. BancShares' prospective capacity to provide capital to support the growth and expansion of ISB is highly dependent upon FCB's ability to return capital through dividends to BancShares.



**Table of Contents****Financial Summary**

Table 1

(thousands, except per share data and ratios)	Nine Months Ended						
	Third	2006	First	2005	Third	September 30	
	Quarter	Second Quarter	Quarter	Fourth Quarter	Quarter	2006	2005
<b>Summary of Operations</b>							
Interest income	\$ 214,650	\$ 202,499	\$ 190,001	\$ 183,949	\$ 173,534	\$ 607,150	\$ 481,985
Interest expense	96,773	83,566	72,183	66,731	59,306	252,522	151,420
Net interest income	117,877	118,933	117,818	117,218	114,228	354,628	330,565
Provision for credit losses	3,813	2,973	6,737	13,578	7,211	13,523	19,531
Net interest income after provision for credit losses	114,064	115,960	111,081	103,640	107,017	341,105	311,034
Noninterest income	72,605	69,609	65,749	65,457	68,106	207,963	197,895
Noninterest expense	134,865	135,207	131,712	125,395	128,665	401,784	373,961
Income before income taxes	51,804	50,362	45,118	43,702	46,458	147,284	134,968
Income taxes	18,877	18,650	16,461	15,866	16,505	53,988	49,942
Net income	\$ 32,927	\$ 31,712	\$ 28,657	\$ 27,836	\$ 29,953	\$ 93,296	\$ 85,026
Net interest income-taxable equivalent	\$ 118,345	\$ 119,351	\$ 118,226	\$ 117,601	\$ 114,603	\$ 355,922	\$ 331,655
<b>Selected Quarterly Averages</b>							
Total assets	\$ 15,473,638	\$ 15,318,019	\$ 14,694,936	\$ 14,516,620	\$ 14,160,391	\$ 15,105,050	\$ 13,699,234
Investment securities	3,072,113	2,964,308	2,896,711	2,938,833	2,764,377	2,978,353	2,396,451
Loans and leases	10,075,016	9,924,208	9,705,443	9,455,059	9,323,115	9,902,909	9,334,806
Interest-earning assets	13,820,610	13,522,235	13,129,313	13,024,871	12,750,494	13,493,251	12,314,757
Deposits	12,571,525	12,440,125	12,192,664	12,071,673	11,836,193	12,402,826	11,594,227
Interest-bearing liabilities	11,485,378	11,156,821	10,794,420	10,621,384	10,312,675	11,148,071	9,943,013
Long-term obligations	500,564	466,259	408,946	409,612	409,825	458,925	335,105
Shareholders equity	\$ 1,250,197	\$ 1,215,481	\$ 1,191,820	\$ 1,169,113	\$ 1,143,391	\$ 1,219,829	\$ 1,118,609
Shares outstanding	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453
<b>Selected Quarter-End Balances</b>							
Total assets	\$ 15,629,243	\$ 15,526,492	\$ 15,095,210	\$ 14,639,392	\$ 14,484,919	\$ 15,629,243	\$ 14,484,919
Investment securities	3,118,025	3,024,780	2,896,962	2,929,516	2,871,731	3,118,025	2,871,731
Loans and leases	10,129,423	10,029,045	9,810,088	9,642,994	9,359,540	10,129,423	9,359,540
Interest-earning assets	13,818,528	13,685,530	13,455,968	13,053,522	12,996,027	13,818,528	12,996,027
Deposits	12,681,150	12,717,219	12,512,557	12,173,858	12,123,491	12,681,150	12,123,491
Interest-bearing liabilities	11,510,073	11,395,473	11,038,192	10,745,696	10,544,543	11,510,073	10,544,543

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Long-term obligations	424,351	527,478	408,954	408,987	409,742	424,351	409,742
Shareholders equity	\$ 1,272,254	\$ 1,228,579	\$ 1,203,366	\$ 1,181,059	\$ 1,158,885	\$ 1,272,254	\$ 1,158,885
Shares outstanding	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453	10,434,453

**Profitability Ratios  
(averages)**

Rate of return  
(annualized) on:

Total assets	0.84%	0.84%	0.79%	0.76%	0.84%	0.83%	0.83%
Shareholders equity	10.45	10.46	9.75	9.45	10.39	10.23	10.16
Dividend payout ratio	8.70	9.05	10.00	10.30	9.58	9.23	10.12

**Liquidity and Capital  
Ratios (averages)**

Loans and leases to deposits	80.14%	79.78%	79.60%	78.32%	78.77%	79.84%	80.51%
Shareholders equity to total assets	8.08	7.93	8.11	8.05	8.07	8.08	8.17
Time certificates of \$100,000 or more to total deposits	15.74	15.04	14.44	13.45	12.59	15.06	12.24

**Per Share of Stock**

Net income	\$ 3.16	\$ 3.04	\$ 2.75	\$ 2.67	\$ 2.87	\$ 8.94	\$ 8.15
Cash dividends	0.275	0.275	0.275	0.275	0.275	0.825	0.825
Book value at period end	121.93	117.74	115.33	113.19	111.06	121.93	111.06
Tangible book value at period end	111.26	107.02	104.55	102.35	100.17	111.26	100.17

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**INTEREST-EARNING ASSETS**

Interest-earning assets include loans and leases, investment securities and overnight investments, all of which reflect varying interest rates based on the risk level and maturity of the underlying asset. Accordingly, riskier investments typically carry a higher interest rate, but expose the investor to potentially higher levels of default. We have historically focused on maintaining high asset quality, which results in a loan portfolio subjected to strenuous underwriting and monitoring procedures. Our investment securities portfolio consists almost exclusively of high-quality assets, primarily United States Treasury and government agency securities. Generally, the investment securities portfolio grows and shrinks based on loan and deposit trends. When deposit growth exceeds loan demand, we invest excess funds in the securities portfolio. Conversely, when loan demand exceeds deposit growth, we use proceeds from maturing securities to fund loan demand. Overnight investments are selectively made with other financial institutions that are within our risk tolerance.

Interest-earning assets for the third quarter of 2006 averaged \$13.82 billion, an increase of \$1.07 billion or 8.4 percent from the third quarter of 2005. For the nine months ended September 30, 2006, interest-earning assets averaged \$13.49 billion, an increase of \$1.18 billion or 9.6 percent over the same period of 2005. These increases primarily resulted from growth in the loan and lease portfolio and investment securities.

Loans and leases. At September 30, 2006 and 2005, loans and leases totaled \$10.13 billion and \$9.36 billion, respectively. The \$769.9 million growth in loans and leases from September 30, 2005 to September 30, 2006 primarily reflects growth within BancShares' commercial and industrial, commercial mortgage and construction and land development lending. Table 2 details outstanding loans and leases by type for the past five quarters. During the twelve-month period from September 30, 2005 to September 30, 2006, FCB's loan growth rate was 6.9 percent, compared to 14.6 percent at ISB. ISB's rate of loan growth continues to exceed that of FCB due to the rapid increase in loan balances that are typically experienced during the initial three-year period after entry into new markets.

Commercial real estate loans totaled \$3.63 billion at September 30, 2006, 35.8 percent of total loans and leases. This represents an increase of \$161.1 million or 4.6 percent since September 30, 2005. Both FCB and ISB have experienced continuing demand for commercial real estate financing in recent quarters. A large percentage of our commercial real estate loans are secured by owner-occupied properties, and were underwritten based primarily upon the cash flow from the operation of the business rather than the value of the underlying real estate collateral.

During the 12-month period ended September 30, 2006, we also experienced a \$414.9 million or 40.1 percent increase in commercial and industrial loans, generated primarily in ISB markets. In addition, we recorded \$144.6 million in loans made in conjunction with the United States Department of Agriculture tobacco buyout program. Commercial and industrial loans totaled \$1.45 billion at September 30, 2006, 14.3 percent of total loans and leases, compared to \$1.03 billion at September 30, 2005.

Revolving mortgage loans totaled \$1.33 billion at September 30, 2006, representing 13.1 percent of total loans outstanding. This component of the loan portfolio has decreased \$44.1 million since September 30, 2005, a trend we largely attribute to the flat yield curve making long-term fixed-rate financing relatively attractive versus variable rate revolving loans.

During the third quarter of 2006, total loans and leases averaged \$10.08 billion, an increase of \$751.9 million or 8.1 percent from the comparable period of 2005. For the year-to-date, total loans and leases have averaged \$9.90 billion for 2006 compared to \$9.33 billion for the same period of 2005, an increase of \$568.1 million or 6.1 percent increase over the prior year.

We continue to focus on expansion of banking services to the medical community. At September 30, 2006, 12.3 percent of our loan portfolio represented loans for office facilities, medical and dental equipment and other needs incidental to the respective area of practice. We do not believe that the focus on medical and dental lending presents an inappropriate risk to the overall quality of our loan and lease portfolio.

Our continuing growth in new markets has allowed us to mitigate our geographic concentration in North Carolina and Virginia. Although we are pleased with the diversification that we have realized through the growth of ISB, we are aware that, in the absence of rigorous underwriting and monitoring controls, rapid loan and lease growth in new markets may present incremental lending risks. During the expansion of ISB into new markets, we have endeavored to ensure that such controls are functioning effectively and will continue to place emphasis upon maintaining strong lending standards in new markets.

**Table of Contents****Outstanding Loans and Leases by Type**

Table 2

(thousands)	Third Quarter	2006		2005	
		Second Quarter	First Quarter	Fourth Quarter	Third Quarter
Real estate:					
Construction and land development	\$ 833,505	\$ 822,687	\$ 821,477	\$ 766,945	\$ 716,176
Commercial mortgage	3,626,600	3,591,372	3,530,296	3,518,563	3,465,494
Residential mortgage	1,040,202	1,007,616	979,572	1,016,677	990,355
Revolving mortgage	1,331,055	1,368,584	1,359,483	1,368,729	1,375,145
Other mortgage	167,238	172,322	173,819	172,712	179,217
Total real estate	6,998,600	6,962,581	6,864,647	6,843,626	6,726,387
Commercial and industrial	1,448,554	1,417,341	1,326,182	1,193,349	1,033,650
Consumer	1,331,597	1,330,852	1,312,790	1,318,971	1,320,232
Lease financing	284,230	259,253	246,544	233,499	213,603
Other	66,442	59,018	59,925	53,549	65,668
Total loans and leases	10,129,423	10,029,045	9,810,088	9,642,994	9,359,540
Less allowance for loan and lease losses	131,652	130,532	130,222	128,847	126,297
Net loans and leases	\$ 9,997,771	\$ 9,898,513	\$ 9,679,866	\$ 9,514,147	\$ 9,233,243

**Investment securities.** At September 30, 2006 and 2005, the investment securities portfolio totaled \$3.12 billion and \$2.87 billion, respectively. Total investment securities have increased 8.6 percent since September 30, 2005. Table 3 presents detailed information relating to the investment securities portfolio. During 2006, growth in deposits and master notes has exceeded loan demand, resulting in excess liquidity that has been invested in the investment securities portfolio. In addition to deposit growth, investable liquidity resulted from the \$115.0 million in trust preferred securities issued during the second quarter of 2006.

Investment securities held to maturity totaled \$287.2 million at September 30, 2006, compared to \$696.9 million at September 30, 2005. This component of our investment securities portfolio continues to decline as securities mature and virtually all newly-purchased investment securities are classified as available for sale. The average maturity of the held-to-maturity portfolio increased from ten months at September 30, 2005 to thirteen months at September 30, 2006. Securities classified as held-to-maturity reflect BancShares' ability and positive intent to hold those investments until maturity.

Investment securities available for sale totaled \$2.83 billion at September 30, 2006, compared to \$2.17 billion at September 30, 2005, a \$656.0 million or 30.2 percent increase. Available-for-sale securities are reported at their aggregate fair value.

**Income on interest-earning assets.** Interest income amounted to \$214.7 million during the third quarter of 2006, a \$41.1 million or 23.7 percent increase from the third quarter of 2005. This increase resulted from higher yields as well as healthy growth in interest-earning assets. The taxable-equivalent yield on interest-earning assets increased 76 basis points from 5.42 percent in the third quarter of 2005 to 6.18 percent in the third quarter of 2006.

Loan interest income for the third quarter of 2006 was \$175.3 million, an increase of \$29.3 million or 20.0 percent from the third quarter of 2005, due to improved loan yields and growth in the loan portfolio. The taxable-equivalent yield on average loans grew from 6.24 percent to 6.93 percent from the third quarter of 2005 to the third quarter of 2006 due to higher market rates.

Within the investment securities portfolio, interest income amounted to \$30.5 million during the third quarter of 2006 compared to \$21.8 million during the third quarter of 2005, an increase of \$8.7 million or 39.7 percent. The increase in interest income resulted from higher yields and growth in average investment securities. Average investment securities increased \$307.7 million or 11.1 percent in the third quarter of 2006 when compared to the same period of 2005.

Overnight investments generated interest income of \$8.9 million during the third quarter of 2006, compared to \$5.7 million during the same period of 2005. The higher income is primarily the result of substantially higher yields.

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Interest income totaled \$607.2 million during the first nine months of 2006, a \$125.2 million or 26.0 percent increase from the same period of 2005, the combined result of favorable rate and volume variances. The taxable-equivalent yield on interest-earning assets increased 78 basis points from 5.25 percent for the first nine months of 2005 to 6.03 percent during the same period of 2006. Higher market interest rates during 2006 contributed to the favorable rate variance.

**Table of Contents****Investment Securities**

Table 3

(thousands)	September 30, 2006				September 30, 2005			
	Cost	Fair Value	Average Maturity (Yrs./Mos.)	Taxable Equivalent Yield	Cost	Fair Value	Average Maturity (Yrs./Mos.)	Taxable Equivalent Yield
<b>Investment securities available for sale:</b>								
U. S. Government:								
Within one year	\$ 1,473,897	\$ 1,460,075	0/5	3.47	\$ 1,090,549	\$ 1,073,866	0/4	2.85
One to five years	1,235,798	1,233,452	1/8	4.74	1,000,452	992,261	1/9	3.73
Five to ten years	6,383	6,153	6/9	4.88	125	120	5/10	5.44
Ten to twenty years	2,863	2,770	13/9	4.92	2,198	2,141	13/2	4.76
Over twenty years	51,667	50,492	28/5	5.35	28,823	28,477	28/5	5.34
<b>Total</b>	<b>2,770,608</b>	<b>2,752,942</b>	<b>1/6</b>	<b>4.08</b>	<b>2,122,147</b>	<b>2,096,865</b>	<b>1/5</b>	<b>3.30</b>
State, county and municipal:								
Within one year	931	926	0/7	2.96	909	903	0/8	2.01
One to five years	2,309	2,283	2/7	3.91	3,077	3,046	2/10	3.54
Five to ten years	903	906	5/10	4.67	1,116	1,114	6/7	4.64
Ten to twenty years								
Over twenty years	160	161	25/9	3.27	145	145	27/2	1.15
<b>Total</b>	<b>4,303</b>	<b>4,276</b>	<b>3/10</b>	<b>3.84</b>	<b>5,247</b>	<b>5,208</b>	<b>3/11</b>	<b>3.44</b>
Other								
Within one year								
One to five years								
Ten to twenty years	10,920	10,920	11/8	11.08	11,586	12,226	12/2	11.18
Five to ten years								
<b>Total</b>	<b>10,920</b>	<b>10,920</b>	<b>11/8</b>	<b>11.08</b>	<b>11,586</b>	<b>12,226</b>		
Equity securities	35,695	62,672			34,416	60,504		
<b>Total investment securities available for sale</b>	<b>\$ 2,821,526</b>	<b>\$ 2,830,810</b>			<b>\$ 2,173,396</b>	<b>\$ 2,174,803</b>		
<b>Investment securities held to maturity:</b>								
U. S. Government:								
Within one year	\$ 250,072	\$ 248,673	0/5	3.34%	\$ 435,535	\$ 432,297	0/7	2.52%
One to five years	27,805	27,433	1/2	3.65	249,613	247,954	1/6	3.62
Five to ten years	47	47	9/8	6.74				
Ten to twenty years	7,109	7,108	10/7	5.52	9,561	9,747	11/7	5.55
Over twenty years	355	345	22/3	7.15	397	394	23/2	7.25
<b>Total</b>	<b>285,388</b>	<b>283,606</b>	<b>0/9</b>	<b>3.43</b>	<b>695,106</b>	<b>690,392</b>	<b>1/1</b>	<b>2.96</b>
State, county and municipal:								
Within one year								
One to five years	148	154	2/7	5.88	147	155	3/7	5.88
Five to ten years								
Ten to twenty years	1,429	1,556	11/7	6.02	1,425	1,567	12/7	6.02
<b>Total</b>	<b>1,577</b>	<b>1,710</b>	<b>10/9</b>	<b>6.01</b>	<b>1,572</b>	<b>1,722</b>	<b>11/9</b>	<b>6.01</b>

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Other								
Within one year								
One to five years	250	250	1/10	3.25	250	250	2/10	7.75
Five to ten years								
Total	250	250	1/10	3.25	250	250	2/10	7.75
Total investment securities held to maturity	287,215	285,566	1/1	2.97	696,928	692,364	1/1	2.97
Total investment securities	\$ 3,108,741	\$ 3,116,376			\$ 2,870,324	\$ 2,867,167		

Average maturity assumes callable securities mature on their earliest call date; yields are based on amortized cost; yields related to securities that are exempt from federal and/or state income taxes are stated on a taxable-equivalent basis assuming statutory rates of 35% for federal income tax purposes and 6.9% for state income taxes for all periods.

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For the nine months ended September 30, 2006, loan interest income was \$501.7 million, an increase of \$83.9 million or 20.1 percent from the same period of 2005. The increase in interest income reflects higher interest rates and growth in the loan portfolio. For the first nine months of 2006, the taxable-equivalent loan yield was 6.79 percent compared to 6.00 percent during the same period of 2005, up 79 basis points.

For the nine months ended September 30, 2006, income earned on the investment securities portfolio amounted to \$83.1 million, compared to \$51.3 million during the same period of 2005, an increase of \$31.8 million or 62.0 percent. This increase is the combined result of an 86 basis point increase in the taxable-equivalent yield and a \$581.9 million increase in average investment securities. Due to a 193 basis point yield increase, interest earned on overnight investments increased by \$9.4 million, or 73.0 percent, during the first nine months of 2006 compared to the same period of 2005.

## **INTEREST-BEARING LIABILITIES**

Interest-bearing liabilities include interest-bearing deposits as well as short-term borrowings and long-term obligations. Deposits are our primary funding source, although we also utilize non-deposit borrowings to fulfill commercial customer requirements for cash management services and to stabilize our liquidity base. Certain of our long-term borrowings also provide capital strength under existing guidelines established by the Federal Reserve Bank and other banking regulators.

During the third quarter of 2006, interest-bearing liabilities averaged \$11.49 billion, an increase of \$1.17 billion or 11.4 percent from the third quarter of 2005. This increase primarily resulted from higher levels of time deposits as customers shifted funds from money market and other short-term deposit products to time deposits in order to take advantage of higher market interest rates. Master notes also experienced strong growth due to customer demand.

Deposits. At September 30, 2006, total deposits were \$12.68 billion, an increase of \$557.7 million or 4.6 percent over September 30, 2005. Interest-bearing deposits averaged \$9.94 billion during the third quarter of 2006 compared to \$9.24 billion during the third quarter of 2005, an increase of \$699.1 million or 7.6 percent. Average time deposits increased \$873.1 million or 20.5 percent to \$5.14 billion while money market balances remained stable at \$2.68 billion. Average balances of both savings and Checking With Interest declined as compared to the same quarter of 2005.

For the first nine months of 2006, interest-bearing deposits averaged \$9.78 billion compared to \$9.06 billion during the same period of 2005. This \$712.2 million or 7.9 percent increase results from substantial growth in time deposits due to customer rotation of liquidity from short-term deposit instruments.

Short-term borrowings. At September 30, 2006, short-term borrowings totaled \$1.13 billion compared to \$696.9 million at September 30, 2005. For the quarters ended September 30, 2006 and 2005, short-term borrowings averaged \$1.04 billion and \$661.4 million, respectively. The \$382.8 million or 57.9 percent increase in average short-term borrowings is the result of the growth in master notes. Customer interest in these commercial cash management products has improved due to increased interest rates making these sweep products attractive investment alternatives. A similar increase was noted in average balances for the nine-month period ended September 30, 2006 versus September 30, 2005.

Long-term obligations. At September 30, 2006 and 2005, long-term obligations totaled \$424.4 million and \$409.7 million, respectively. The increase reflects the impact of \$115 million in trust preferred securities issued during the second quarter of 2006.

For September 30, 2005, long-term obligations included \$100.0 million in trust preferred capital securities issued in 2001 (the 2001 Securities). The 2001 Securities had a scheduled maturity date in 2031, but were called on October 31, 2006. The 2001 Securities were included in other short-term borrowings as of September 30, 2006.



**Table of Contents****Consolidated Taxable Equivalent Rate/Volume Variance Analysis - Third Quarter**

Table 4

(thousands)	2006			2005			Increase (decrease) due to:		Total Change	
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Volume	Yield/ Rate		
<b>Assets</b>										
Loans and leases	\$ 10,075,016	\$ 175,723	6.93%	\$ 9,323,115	\$ 146,355	6.24%	\$ 12,463	\$ 16,905	\$ 29,368	
Investment securities:										
U. S. Government	2,993,301	29,615	3.93	2,689,999	21,031	3.10	2,663	5,921	8,584	
State, county and municipal	5,828	81	5.51	6,808	90	5.24	(13)	4	(9)	
Other	72,984	846	4.60	67,570	746	4.38	61	39	100	
Total investment securities	3,072,113	30,542	3.94	2,764,377	21,867	3.14	2,711	5,964	8,675	
Overnight investments	673,481	8,853	5.22	663,002	5,687	3.40	107	3,059	3,166	
Total interest-earning assets	\$ 13,820,610	\$ 215,118	6.18%	\$ 12,750,494	\$ 173,909	5.42%	\$ 15,281	\$ 25,928	\$ 41,209	
<b>Liabilities</b>										
Deposits:										
Checking With Interest	\$ 1,486,969	\$ 462	0.12%	\$ 1,572,391	\$ 489	0.12%	\$ (26)	\$ (1)	\$ (27)	
Savings	631,265	337	0.21	734,836	384	0.21	(51)	4	(47)	
Money market accounts	2,684,308	21,693	3.21	2,669,273	13,871	2.06	81	7,741	7,822	
Time deposits	5,138,065	53,498	4.13	4,264,966	32,732	3.04	7,869	12,897	20,766	
Total interest-bearing deposits	9,940,607	75,990	3.03	9,241,466	47,476	2.04	7,873	20,641	28,514	
Federal funds purchased	35,235	448	5.04	47,619	400	3.33	(131)	179	48	
Repurchase agreements	231,291	2,142	3.67	144,583	689	1.89	609	844	1,453	
Master notes	693,344	7,820	4.47	413,929	2,804	2.69	2,527	2,489	5,016	
Other short-term borrowings	84,337	1,391	6.54	55,253	480	3.45	367	544	911	
Long-term obligations	500,564	8,982	7.18	409,825	7,457	7.28	1,639	(114)	1,525	
Total interest-bearing liabilities	\$ 11,485,378	\$ 96,773	3.34%	\$ 10,312,675	\$ 59,306	2.28%	\$ 12,884	\$ 24,583	\$ 37,467	
Interest rate spread			2.84%				3.14%			
Net interest income and net yield										
on interest-earning assets		\$ 118,345	3.40%		\$ 114,603	3.57%	\$ 2,397	\$ 1,345	\$ 3,742	

Average loan balances include nonaccrual loans. Yields related to loans and securities exempt from both federal and state income taxes, federal income taxes only, or state income taxes only are stated on a taxable-equivalent basis assuming a statutory federal income tax rate of 35.0% and state income tax rate of 6.9% for each period. The taxable-equivalent adjustment was \$468 for 2006 and \$375 for 2005.

**Expense on interest-bearing liabilities.** BancShares' interest expense amounted to \$96.8 million during the third quarter of 2006, a \$37.5 million or 63.2 percent increase from the third quarter of 2005. The higher interest expense was the result of higher deposit funding costs caused by escalating market rates and higher average balances of interest-bearing liabilities. The rate on interest-bearing liabilities was 3.34 percent during the third quarter of 2006 compared to 2.28 percent during the same period of 2005.

For the year-to-date, interest expense was \$252.5 million, compared to \$151.4 million for the same period of 2005. The \$101.1 million or 66.8 percent increase results from higher interest rates and higher average volume. The rate on interest-bearing liabilities increased from 2.04 percent during the first nine months of 2005 to 3.03 percent for the same period of 2006, a 99 basis point increase. During 2006, money market deposits have experienced a 106 basis point rate increase, while the rate on time deposits increased 104 basis points.



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**NET INTEREST INCOME**

Net interest income totaled \$117.9 million during the third quarter of 2006, an increase of \$3.6 million or 3.2 percent from the \$114.2 million recorded during the third quarter of 2005. On a linked quarter basis, current quarter net interest income declined by \$1.1 million, or 0.9 percent as compared the second quarter of 2006. The taxable-equivalent net yield on interest-earning assets was 3.40 percent for the third quarter of 2006, down 14 basis points from the previous quarter and 17 basis points from the third quarter of 2005. Net interest income equaled \$354.6 million and \$330.6 million for the nine-month periods ended September 30, 2006 and 2005, respectively, an increase of \$24.1 million or 7.3 percent. The taxable-equivalent net yield on interest-earning assets decreased 7 basis points from 3.60 percent during the first nine months of 2005 to 3.53 percent during the same period of 2006. For both the third quarter and the first nine months of 2006, the unfavorable impact of the flat yield curve and the growing net short-term liability-sensitivity of our balance sheet caused the net yields to decline despite the growth in net interest income.

Our asset/liability management strategy continues to focus on maintaining high levels of balance sheet liquidity and managing our interest rate risk. We maintain portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing characteristics that are designed to protect against wide interest rate fluctuations, thereby limiting, to the extent possible, the ultimate interest rate exposure.

Due to customer preference for fixed-rate commercial loans, rate ceilings that are limiting the repricing of variable rate loans, and surges in shorter-term deposit balances, our interest-sensitivity position has shifted from a net asset-sensitive position to a net liability-sensitive position. Based upon recent trends, it appears that the net liability-sensitivity position will continue to grow into 2007. Assuming no other changes, a net liability sensitive position indicates that rising market interest rates would likely cause a contraction in the net yield on interest-earning assets and, thus, net interest income will decline. Falling market interest rates would create a reverse impact. Changes in the slope of the yield curve and shifts in the mix of interest-earning assets and interest-bearing liabilities may cause actual results to vary.

Historically, we have managed our interest rate risk through decisions regarding pricing and availability of our loan and deposit products and through selected balance sheet management activities such as sales of certain long-term fixed rate residential and revolving loans. We have not relied on interest rate floors, collars or other derivative financial instruments to hedge interest rate sensitivity and interest rate risk. However, during the second quarter of 2006, in conjunction with the issuance of \$115.0 million in trust preferred securities, we entered into an interest rate swap to synthetically convert the variable rate coupon of the securities to a fixed rate of 7.125% for a period of five years.

**Table of Contents****Consolidated Taxable Equivalent Rate/Volume Variance Analysis - Nine Months**

Table 5

(thousands)	2006			2005			Increase (decrease) due to:		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Volume	Yield/Rate	Total Change
<b>Assets</b>									
Loans and leases	\$ 9,902,909	\$ 502,877	6.79%	\$ 9,334,806	\$ 418,743	6.00%	\$ 27,236	\$ 56,898	\$ 84,134
Investment securities:									
U. S. Government	2,899,001	80,484	3.71	2,330,138	49,621	2.85	14,000	16,863	30,863
State, county and municipal	6,284	252	5.36	7,399	283	5.11	(44)	13	(31)
Other	73,068	2,460	4.50	58,914	1,495	3.39	417	548	965
Total investment securities	2,978,353	83,196	3.73	2,396,451	51,399	2.87	14,373	17,424	31,797
Overnight investments	611,989	22,371	4.89	583,500	12,933	2.96	823	8,615	9,438
Total interest-earning assets	\$ 13,493,251	\$ 608,444	6.03%	\$ 12,314,757	\$ 483,075	5.25%	\$ 42,432	\$ 82,937	\$ 125,369
<b>Liabilities</b>									
Deposits:									
Checking With Interest	\$ 1,537,549	\$ 1,411	0.12%	\$ 1,563,338	\$ 1,428	0.12%	\$ (20)	\$ 3	\$ (17)
Savings	664,105	1,056	0.21	746,603	1,140	0.20	(132)	48	(84)
Money market accounts	2,659,822	56,397	2.83	2,631,523	34,851	1.77	529	21,017	21,546
Time deposits	4,914,240	140,735	3.83	4,122,007	85,903	2.79	19,650	35,182	54,832
Total interest-bearing deposits	9,775,716	199,599	2.73	9,063,471	123,322	1.82	20,027	56,250	76,277
Federal funds purchased	40,767	1,434	4.70	44,839	952	2.84	(114)	596	482
Repurchase agreements	196,162	4,929	3.36	138,274	1,496	1.45	1,043	2,390	3,433
Master notes	606,824	18,915	4.17	305,838	5,248	2.29	7,261	6,406	13,667
Other short-term borrowings	69,677	2,692	5.17	55,486	1,288	3.10	437	967	1,404
Long-term obligations	458,925	24,953	7.25	335,105	19,114	7.61	6,905	(1,066)	5,839
Total interest-bearing liabilities	\$ 11,148,071	\$ 252,522	3.03%	\$ 9,943,013	\$ 151,420	2.04%	\$ 35,559	\$ 65,543	\$ 101,102
Interest rate spread			3.00%			3.21%			
Net interest income and net yield on interest-earning assets		\$ 355,922	3.53%		\$ 331,655	3.60%	\$ 6,873	\$ 17,394	\$ 24,267

Average loan balances include nonaccrual loans. Yields related to loans and securities exempt from both federal and state income taxes, federal income taxes only, or state income taxes only, are stated on a taxable-equivalent basis assuming a statutory federal income tax rate of 35.0% and state income tax rate of 0.0% for each period. The taxable-equivalent adjustment was \$1,294 for 2006 and \$1,090 for 2005.

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**ASSET QUALITY**

The maintenance of excellent asset quality is one of our primary areas of operational focus. Historically, we have dedicated significant resources to ensuring that we are prudent in our lending practices. Accordingly, we have focused on asset quality as a key performance measure. Table 6 provides asset quality information for the past five quarters and for the year-to-date for 2006 and 2005.

Nonperforming assets. At September 30, 2006, BancShares' nonperforming assets, consisting of nonaccrual loans and other real estate, amounted to \$25.1 million or 0.25 percent of loans plus other real estate compared to \$15.9 million at September 30, 2005. Nonaccrual loans totaled \$18.3 million at September 30, 2006, compared to \$11.1 million at September 30, 2005, the increase primarily resulting from the fourth quarter 2005 classification of a single large commercial relationship as nonaccrual. Other real estate totaled \$6.7 million at September 30, 2006, compared to \$4.8 million at September 30, 2005. The increase in other real estate is attributable to the transfer from premises and equipment of certain parcels of land that were initially acquired for branch sites. The transfer resulted from the subsequent decision to abandon plans for branch offices at these locations. We closely monitor nonperforming assets, taking necessary actions to minimize potential exposure.

Allowance for credit losses. Our allowance for credit losses includes the allowance for loan and lease losses and the liability for unfunded credit commitments. We continuously analyze the growth and risk characteristics of the total loan and lease portfolio under current economic conditions in order to evaluate the adequacy of the allowance for loan and lease losses. Such factors as the financial condition of the borrower, fair market value of collateral and other considerations are recognized in estimating probable credit losses.

At September 30, 2006, the allowance for credit losses amounted to \$138.2 million or 1.36 percent of loans outstanding. This compares to \$133.2 million or 1.42 percent at September 30, 2005.

The provision for credit losses charged to operations during the third quarter of 2006 equaled \$3.8 million, compared to \$7.2 million during the third quarter of 2005, a decrease of \$3.4 million or 47.1 percent. Net charge-offs for the three months ended September 30, 2006 totaled \$2.7 million, compared to net charge-offs of \$7.2 million during the same period of 2005. On an annualized basis, these net charge-offs represent 0.11 percent and 0.30 percent of average loans and leases outstanding during the respective periods.

For the nine-month periods ended September 30, total provision for credit losses equaled \$13.5 million for 2006 and \$19.5 million for 2005, a decrease of \$6.0 million or 30.8 percent. The reduction in provision expense resulted primarily from lower net charge-offs. Net charge-offs for the nine-month period ended September 30, 2006 totaled \$11.0 million, compared to \$15.6 million during the same period of 2005. As a percentage of average loans and leases outstanding, these losses represent 0.15 percent for 2006 and 0.22 percent for 2005 on an annualized basis.

We consider the established allowance for credit losses adequate to absorb losses inherent in the loan and lease portfolio at September 30, 2006. While we use available information to establish provisions for credit losses, future additions to the allowance may be necessary based on changes in economic conditions or other factors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for credit losses. Such agencies may require the recognition of adjustments based on their judgments of information available to them at the time of their examination.

**Table of Contents****Summary of Loan and Lease Loss Experience and Risk Elements**

Table 6

(thousands, except ratios)	Nine Months Ended							
	Third Quarter	2006			2005		September 30	
		Second Quarter	First Quarter	Fourth Quarter	Third Quarter	2006	2005	
Allowance for credit losses at beginning of period	\$ 137,121	\$ 137,145	\$ 135,770	\$ 133,220	\$ 133,218	\$ 135,770	\$ 130,832	
Provision for credit losses	3,813	2,973	6,737	13,578	7,211	13,523	19,531	
Adjustments					(48)		(1,585)	
Net charge-offs:								
Charge-offs	(4,189)	(4,933)	(7,053)	(12,408)	(8,305)	(16,175)	(20,099)	
Recoveries	1,501	1,936	1,691	1,380	1,144	5,128	4,541	
Net charge-offs	(2,688)	(2,997)	(5,362)	(11,028)	(7,161)	(11,047)	(15,558)	
Allowance for credit losses at end of period	\$ 138,246	\$ 137,121	\$ 137,145	\$ 135,770	\$ 133,220	\$ 138,246	\$ 133,220	
Allowance for credit losses includes:								
Allowance for loan and lease losses	\$ 131,652	\$ 130,532	\$ 130,222	\$ 128,847	\$ 126,297	\$ 131,652	\$ 126,297	
Liability for unfunded credit commitments	6,594	6,589	6,923	6,923	6,923	6,594	6,923	
Allowance for credit losses at end of period	\$ 138,246	\$ 137,121	\$ 137,145	\$ 135,770	\$ 133,220	\$ 138,246	\$ 133,220	
<b>Historical Statistics</b>								
Average loans and leases	\$ 10,075,016	\$ 9,924,208	\$ 9,705,443	\$ 9,455,059	\$ 9,323,115	\$ 9,902,909	\$ 9,334,806	
Loans and leases at period-end	10,129,423	10,029,045	9,810,088	9,642,994	9,359,540	10,129,423	9,359,540	
<b>Risk Elements</b>								
Nonaccrual loans and leases	\$ 18,348	\$ 15,573	\$ 15,844	\$ 18,969	\$ 11,065	\$ 18,348	\$ 11,065	
Other real estate	6,711	8,461	5,573	6,753	4,843	6,711	4,843	
Total nonperforming assets	\$ 25,059	\$ 24,034	\$ 21,417	\$ 25,722	\$ 15,908	\$ 25,059	\$ 15,908	
Accruing loans and leases 90 days or more past due	\$ 6,974	\$ 7,534	\$ 6,729	\$ 9,180	\$ 7,712	\$ 6,974	\$ 7,712	
<b>Ratios</b>								
Net charge-offs (annualized) to average total loans and leases	0.11%	0.12%	0.22%	0.46%	0.30%	0.15%	0.22%	
Percent of total loans and leases at period-end:								
Allowance for loan and lease losses	1.29	1.30	1.33	1.34	1.35	1.30	1.35	
Liability for unfunded credit commitments	0.07	0.07	0.07	0.07	0.07	0.07	0.07	

Allowance for credit losses	1.36	1.37	1.40	1.41	1.42	1.36	1.42
Nonperforming assets to total loans plus other real estate	0.25	0.24	0.22	0.27	0.17	0.25	0.17

**NONINTEREST INCOME**

The growth of noninterest income is essential to our ability to sustain adequate levels of profitability. The primary sources of noninterest income are cardholder and merchant services income, service charges on deposit accounts, various types of commission-based income including the sale of investments by our broker-dealer subsidiaries, fees from processing services for client banks, various types of revenues derived from wealth management services and mortgage income. Noninterest income also includes gains and losses resulting from securities transactions, gains recognized from the securitization and sale of loans and gains recognized on branch sales.

During the first nine months of 2006, noninterest income was \$208.0 million, compared to \$197.9 million during the same period of 2005. The \$10.1 million or 5.1 percent increase resulted from higher cardholder and merchant services income, commission income and fees from processing services. The favorable variances in these areas more than offset the impact of reductions in service charge income.

Cardholder and merchant services income increased \$8.3 million from \$55.6 million earned in the first nine months of 2005 to \$63.9 million in the first nine months of 2006. This 14.9 percent increase in cardholder income was due to higher merchant discount and interchange fees for debit and credit card transactions.

Commission income totaled \$24.7 million during the first nine months of 2006, compared to \$19.5 million during the first nine months of 2005. This \$5.2 million or 26.7 percent increase reflects higher fees from our broker-dealer subsidiaries due in part to stronger sales activity during 2006.

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In the first nine months of 2006, fees from processing services produced \$22.0 million in noninterest income, an increase of \$3.2 million or 16.7 percent from the same time period in 2005. New item processing clients and higher transaction volume for processed banks accounted for the favorable variance.

Trust and asset management fees contributed an additional \$1.6 million during the first nine months of 2006 compared to the same period of 2005. This increase represents an 11.4 percent increase over the same period of 2005, the result of higher fees earned for various trust, fiduciary and asset management services.

Other income decreased \$3.1 million during the first nine months of 2006. During 2005, other income included a gain of \$2.9 million resulting from the securitization and sale of revolving mortgage loans. There were no securitization and sale transactions in 2006. During 2006, other income included a \$936,000 gain that resulted from sale of a branch.

Service charge income decreased \$3.4 million or 5.9 percent from the \$57.9 million earned during the first nine months of 2005. Much of the reduction relates to commercial service charge income, which has declined as interest rates have increased for accounts subject to commercial analysis.

During the third quarter of 2006, noninterest income was \$72.6 million, a \$4.5 million or 6.6 percent increase over the \$68.1 million earned during the third quarter of 2005. Cardholder and merchant services income increased \$3.0 million or 15.0 percent during 2006 due to higher merchant discount and interchange income for debit and credit transactions. Commission income increased \$1.8 million due to improved broker-dealer revenues generated during 2006. Fees from processing services increased \$1.2 million or 18.7 percent.

Partially offsetting these increases, service charges on deposit accounts decreased \$1.5 million or 7.8 percent during the third quarter of 2006 due to reductions in commercial service charge income.

## **NONINTEREST EXPENSE**

The primary components of noninterest expense are salaries and related employee benefit costs, occupancy costs related to branch offices and support facilities, equipment costs and other operating costs. Noninterest expense amounted to \$401.8 million for the first nine months of 2006, a 7.4 percent increase over the \$374.0 million recorded during the same period of 2005. The \$27.8 million increase in noninterest expense results from higher personnel and general operating costs. ISB noninterest expenses increased \$6.0 million or 12.4 percent over 2005 due to branch expansion.

Salary expense increased \$13.1 million during 2006 when compared to the same period of 2005. This 8.2 percent increase is due to higher incentive compensation costs and incremental staff costs for new branch offices in both FCB, ISB and support functions. Incentive compensation increased \$3.1 million or 29.3 percent during the first nine months of 2006, primarily due to higher wealth management incentives. ISB's salary expense increased \$2.5 million or 12.4 percent as additional personnel costs were incurred to staff new offices.

Employee benefits expense decreased \$598,000 or 1.5 percent during the first nine months of 2006, compared to the corresponding period of 2005. This reduction reflects the favorable impact of a \$2.1 million reduction in pension expense and the absence of a \$1.8 million expense recorded during 2005 to adjust the accrued liability for a post-retirement benefit plan for certain executive officers. These items were partially offset by a \$2.6 million increase in health and disability costs.

Occupancy expense increased \$3.6 million to \$38.6 million during the first nine months of 2006. This 10.4 percent increase resulted from higher depreciation and rent expense for branch facilities and incremental costs associated with a new corporate headquarters building. As a result of additional locations, ISB's occupancy expense increased \$1.4 million or 16.7 percent during 2006.

Other expenses increased \$10.1 million or 9.8 percent during the first nine months of 2006 when compared to the first nine months of 2005. Increases in other noninterest expense occurred in cardholder processing costs, courier expense and costs related to various cardholder loyalty programs.

For the third quarter of 2006, noninterest expense totaled \$134.9 million, a \$6.2 million or 4.8 percent increase over the same period of 2005. Salary expense totaled \$59.3 million during the third quarter of 2006, an increase of \$3.7 million or 6.6 percent due primarily to costs for new associates hired to support the continuing branch expansion. Occupancy expense increased \$1.3 million or 10.4 percent due to higher building costs.





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### **INCOME TAXES**

BancShares continually monitors and evaluates the potential impact of current events on the estimates used to establish income tax expenses and income tax liabilities. On a periodic basis, we evaluate our income tax positions based on current tax law, positions taken by various tax auditors within the jurisdictions that BancShares is required to file income tax returns as well as potential or pending audits or assessments by tax auditors.

For the third quarters of 2006 and 2005, the effective tax rates were 36.4 percent and 35.5 percent, respectively. The effective tax rates for the nine-month periods ended September 30, 2006 and 2005 were 36.7 percent and 37.0 percent, respectively.

### **LIQUIDITY**

BancShares has historically maintained a strong focus on liquidity, and our deposit base represents our primary liquidity source. Through our deposit pricing strategies, we have the ability to stimulate or curtail deposit growth. BancShares also maintains additional sources for borrowed funds through federal funds lines of credit and other borrowing facilities. At September 30, 2006, BancShares had access to \$525.0 million in unfunded borrowings through its correspondent bank network.

Once we have satisfied our loan demand, residual liquidity is invested in overnight and longer-term investment products. Investment securities available for sale provide immediate liquidity as needed. In addition, investment securities held to maturity provide an ongoing liquidity source based on the scheduled maturity dates of the securities.

On October 31, 2006, BancShares redeemed \$100.0 million of trust preferred securities that had been issued in 2001.

### **SHAREHOLDERS EQUITY AND CAPITAL ADEQUACY**

BancShares continues to exceed all minimum regulatory capital requirements, and the banking subsidiaries remain well-capitalized. At September 30, 2006 and 2005, the leverage capital ratio of BancShares was 9.90 percent and 9.22 percent, respectively, surpassing the minimum level of 3 percent. As a percentage of risk-adjusted assets, BancShares Tier 1 capital ratio was 13.61 percent at September 30, 2006, and 12.51 percent as of September 30, 2005. The minimum ratio allowed is 4 percent of risk-adjusted assets. The total risk-adjusted capital ratio was 16.07 percent at September 30, 2006 and 15.08 percent as of September 30, 2005. The minimum total capital ratio is 8 percent.

The trust preferred securities issued during the second quarter of 2006 qualify as Tier 1 capital under current regulatory guidelines. As a result, BancShares total capital ratio was further strengthened by that transaction. However, due to the October 31, 2006 redemption of the \$100.0 million in trust preferred securities issued during 2001, BancShares capital ratios will decline. BancShares, FCB and ISB will remain well-capitalized following the redemption.

### **SEGMENT REPORTING**

BancShares conducts its banking operations through its two banking subsidiaries, FCB and ISB. Although FCB and ISB offer similar products and services to customers, each entity operates in distinct geographic markets and has separate management groups. We monitor growth and financial results in these institutions separately and, within each institution, by geographic segregation.

Although FCB has grown through acquisition in certain of its markets, throughout its history much of its expansion has been accomplished on a de novo basis. However, because of FCB's size, market share and maturity as well as the current modest expansion of its branch network, the costs associated with de novo branching are not material to FCB's financial performance. Since it first opened in 1997, ISB has followed a similar business model for growth and expansion. Yet, due to the large number of branch offices that have yet to attain sufficient size for profitability, the financial results and trends of ISB are significantly affected by its current and continuing growth. Each new market ISB enters creates additional operating costs that are typically not fully offset by operating revenues until the third year after initial opening. ISB's rapid growth in new markets in recent years has continued to adversely impact its financial performance.

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**ISB.** ISB's total assets increased from \$1.78 billion at September 30, 2005 to \$2.06 billion at September 30, 2006, an increase of \$282.7 million or 15.9 percent. ISB's net interest income increased \$5.2 million or 11.5 percent during the first nine months of 2006, when compared to the same period of 2005, the result of higher loan yields and higher levels of average loans and leases. Provision for credit losses decreased \$4.3 million or 64.4 percent due to lower net charge-offs and reduced loan growth.

ISB's noninterest income increased \$2.8 million or 51.5 percent during the first nine months of 2006, due to higher working capital finance and cardholder and merchant services income, partially offset by a reduction in mortgage income. Noninterest expense increased \$6.0 million or 12.4 percent during 2006, caused by higher personnel, occupancy and card processing costs. Higher personnel and occupancy result from the continuing expansion of the ISB branch network .

ISB recorded net income of \$654,000 during the first nine months of 2006 compared to a net loss of \$3.3 million during the same period of 2005. This represents a favorable variance of \$3.9 million, the result of a higher revenues and lower provision costs.

ISB continues to evaluate both existing and new markets for expansion. As such growth occurs, ISB will continue to incur incremental personnel and occupancy costs. As a result of the de novo status of much of the ISB franchise and plans for continued expansion, ISB's profitability will likely remain low for the foreseeable future.

**FCB.** FCB's total assets increased from \$12.59 billion at September 30, 2005 to \$13.43 billion at September 30, 2006, an increase of \$842.0 million or 6.7 percent. FCB's net interest income increased \$21.6 million or 7.2 percent during the first nine months of 2006, the result of higher loan yields and loan growth. Provision for credit losses decreased \$1.7 million or 13.5 percent due to lower net charge-offs.

FCB's noninterest income increased \$8.3 million or 4.2 percent during the first nine months of 2006, primarily the result of cardholder and merchant income and commission income. Noninterest expense increased \$22.7 million or 6.9 percent during the first nine months of 2006, primarily due to higher personnel, occupancy and card processing costs.

FCB recorded net income of \$104.2 million during the first nine months of 2006 compared to \$98.0 million during the same period of 2005. This represents a \$6.2 million or 6.3 percent increase in net income, reflecting the favorable impact on net interest income of increases in market interest rates during the past 12 months.

## **CURRENT ACCOUNTING AND REGULATORY ISSUES**

In November 2003, the Emerging Issues Task Force ( EITF ) issued EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments ( EITF 03- 01 ). In September 2004, the Financial Accounting Standards Board (FASB) issued a FASB Staff Position (FSP EITF 03-1-b). In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1. Collectively, these documents consider when an investment is considered impaired, what disclosures are appropriate for impairment losses, and what disclosures are appropriate for unrealized losses that have not been recognized as other-than-temporary impairments. The new disclosure requirements are effective for reporting periods beginning after December 15, 2005.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 (SFAS 154), Accounting Changes and Error Corrections , which replaces prior accounting guidance related to accounting changes and error corrections. SFAS 154 changes the requirements for the accounting for and reporting of a change in an accounting principle. SFAS 154 requires retrospective application for voluntary changes in an accounting principle unless it is impracticable to do so. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. We adopted SFAS 154 on January 1, 2006. There will be no material impact on our consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies uncertainty in income taxes recognized by establishing a recognition threshold and a measurement attribute for the financial statement treatment of a tax position taken or expected to be taken in a tax return. FIN 48 is effective January 1, 2007. We continue to evaluate the impact that FIN 48 may ultimately have on our consolidated financial statements.

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In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 Fair Value Measurements (Statement 157). Statement 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Statement 157 does not require any new fair value measurements, but clarifies and standardizes some divergent practices that have emerged since prior guidance was issued. Statement 157 will become effective for BancShares on January 1, 2008. There will be no material impact on our consolidated financial statements.

In September 2006, the FASB issued Summary of Statement No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (Statement 158). Statement 158 requires sponsors of defined benefit and other post-retirement plans to recognize the overfunded or underfunded status of that plan as an asset or liability in the sponsor's statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The recognition of the funded status of the defined benefit plan and additional disclosures outlined in Statement 158 will be included in BancShares' December 31, 2006 consolidated financial statements. The impact of that recognition will not be known until the fair value of the plan assets is known. Statement 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, although that requirement is not effective until 2008.

Management is not aware of any current recommendations by regulatory authorities that, if implemented, would have or would be reasonably likely to have a material effect on liquidity, capital ratios or results of operations.

## **FORWARD-LOOKING STATEMENTS**

Statements in this Report and exhibits relating to plans, strategies, economic performance and trends, projections of results of specific activities or investments, expectations or beliefs about future events or results, and other statements that are not descriptions of historical facts, may be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

Forward-looking information is inherently subject to risks and uncertainties, and actual results could differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in our Annual Report on Form 10-K and in other documents filed by us from time to time with the Securities and Exchange Commission.

Forward-looking statements may be identified by terms such as may, will, should, could, expects, plans, intends, anticipates, believe, predicts, forecasts, projects, potential or continue, or similar terms or the negative of these terms, or other statements concerning opinions or judgments of BancShares' management about future events.

Factors that could influence the accuracy of those forward-looking statements include, but are not limited to, the financial success or changing strategies of our customers, customer acceptance of our services, products and fee structure, the competitive nature of the financial services industry, our ability to compete effectively against other financial institutions in our banking markets, actions of government regulators, the level of market interest rates and our ability to manage our interest rate risk, changes in general economic conditions particularly changes that affect our loan and lease portfolio, the abilities of our borrowers to repay their loans and leases, and the values of collateral, and other developments or changes in our business that we do not expect.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We have no obligation to update these forward-looking statements.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the potential economic loss resulting from changes in market prices and interest rates. This risk can either result in diminished current fair values of financial instruments or reduced net interest income in future periods. As of September 30, 2006, BancShares' market risk profile has not changed significantly from December 31, 2005. Changes in fair value that result from movement in market rates cannot be predicted with any degree of certainty. Therefore, the impact that future changes in market rates will have on the fair values of financial instruments is uncertain.

Item 4. Controls and Procedures

BancShares' management, with the participation of its Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of BancShares' disclosure controls and procedures in accordance with Rule 13a-15 of the Securities Exchange Act of 1934 (Exchange Act). Based on their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, BancShares' disclosure controls and procedures were effective in enabling it to record, process, summarize and report in a timely manner the information required to be disclosed in reports it files under the Exchange Act.

No change in BancShares' internal control over financial reporting occurred during the third quarter of 2006 that had materially affected, or is reasonably likely to materially affect, BancShares' internal control over financial reporting.

PART II

Item 6. Exhibits

- 31.1 Certification of Chief Executive Officer
- 31.2 Certification of Chief Financial Officer
- 32 Certifications of Chief Executive Officer and Chief Financial Officer

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SIGNATURES

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

Dated: November 7, 2006

FIRST CITIZENS BANCSHARES, INC.

(Registrant)

By: /s/ Kenneth A. Black  
Kenneth A. Black  
Vice President, Treasurer  
and Chief Financial Officer

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