FIRST CHARTER CORP /NC/
Form 10-K
March 15, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended December 31, 2005

OR

o **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 0-15829
FIRST CHARTER CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

North Carolina	**56-1355866**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*
10200 David Taylor Drive, Charlotte, NC	**28262-2373**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s telephone number, including area code **(704) 688-4300**
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
N/A	N/A

Securities registered pursuant to Section 12(g) of the Act:
Title of Each Class
Common stock, no par value
Series X Junior Participating Preferred Stock Purchase Rights

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The aggregate market value of the registrant s common stock held by non-affiliates of the registrant as of June 30, 2005 was $630,483,560 based on the closing sale price of the registrant s common stock as reported on the NASDAQ National Market.

As of March 8, 2006 the registrant had outstanding 30,880,174 shares of common stock, no par value.

Documents Incorporated by Reference

PART III: Definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company s 2006 Annual Meeting of Shareholders to be held on April 26, 2006. (With the exception of those portions which are specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed or incorporated by reference as part of this report.)

FIRST CHARTER CORPORATION
AND SUBSIDIARIES
FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005
TABLE OF CONTENTS
PART I

		Page
Item 1.	Business	3
Item 1A.	Risk Factors	9
Item 1B.	Unresolved Staff Comments	17
Item 2.	Properties	17
Item 3.	Legal Proceedings	17
Item 4.	Submission of Matters to a Vote of Security Holders	17
Item 4A.	Executive Officers of the Registrant	18

PART II

Item 5.	Market For Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	19
Item 6.	Selected Financial Data	21
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	21
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk	51
Item 8.	Financial Statements and Supplementary Data	52
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	89
Item 9A.	Controls and Procedures	89
Item 9B.	Other Information	89

PART III

Item 10.	Directors and Executive Officers of the Registrant	90
Item 11.	Executive Compensation	90
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	90
Item 13.	Certain Relationships and Related Transactions	90
Item 14.	Principal Accountant Fees and Services	90

PART IV

Item 15.	Exhibits and Financial Statement Schedules	91

Part I

Item 1. ***Business***

General

First Charter Corporation (hereinafter referred to as either the Registrant , First Charter or the Corporation) is a bank holding company established as a North Carolina Corporation in 1983 and is registered under the Bank Holding Company Act of 1956, as amended (the BHCA). Its principal asset is the stock of its subsidiary, First Charter Bank (the Bank). The principal executive offices of the Corporation are located at 10200 David Taylor Drive, Charlotte, North Carolina 28262. The telephone number is (704) 688-4300.

First Charter Bank, a North Carolina state bank, is the successor entity to The Concord National Bank, which was established in 1888. On April 4, 2000, the Corporation acquired Carolina First BancShares, Inc. (Carolina First), the holding company for Lincoln Bank, Cabarrus Bank and Community Bank & Trust, which merged into the Corporation. Carolina First was a North Carolina corporation and operated through its subsidiary banks and 31 branch offices principally in the greater Charlotte, North Carolina area. On September 1, 2000, Business Insurers of Guilford County (Business Insurers) was merged into First Charter Insurance Services. Each of these mergers was accounted for using the pooling of interests method and accordingly, all financial information presented herein has been restated for all periods presented to reflect the mergers. On June 22, 2001, First Charter s banking subsidiary converted from a national bank to First Charter Bank, a North Carolina state bank. The conversion was completed after a cost-benefit analysis of supervisory regulatory charges and did not represent any disagreement with the Corporation s or the Bank s former regulators. The Bank continues to operate its financial center network franchise under the First Charter brand name.

On December 31, 2005, First Charter Bank, a full service bank, operated 55 financial centers and four insurance offices, as well as 137 ATMs (automated teller machines) throughout North Carolina. The Bank also operates loan origination offices in Asheville, North Carolina and Reston, Virginia.

The Corporation s primary market area is located within North Carolina and is centered primarily around the Charlotte Metro region, including Mecklenburg County and its surrounding counties. Charlotte is the twenty-first largest city in the United States and has a diverse economic base. Primary business sectors in the Charlotte Metro region include banking and finance, insurance, manufacturing, health care, transportation, retail, telecommunications, government services and education. The Corporation entered the Raleigh, North Carolina market in 2005 by opening a loan production office in the first quarter of 2005 and a financial center in the fourth quarter of 2005. Raleigh has an economic base similar to that found in Charlotte. The Corporation believes that it is not dependent on any one or a few types of commerce due to the diverse economic base of the Charlotte Metro region and the Raleigh market. Since the North Carolina economy has historically relied on the manufacturing and transportation sectors, it has been significantly impacted by global competition and rising energy prices. As a result, the North Carolina economy is transitioning to a more service-oriented economy. Recently, the education, healthcare, information technology, finance and business services industries have shown the most growth.

Through its financial centers, the Bank provides a wide range of banking products, including interest-bearing and noninterest-bearing checking accounts, money market accounts, certificates of deposit, individual retirement accounts, full service and discount brokerage services including annuity sales, overdraft protection, financial planning services, personal and corporate trust services, safe deposit boxes, and online banking. The Bank also provides commercial, consumer, real estate, residential mortgage and home equity loans.

In addition, the Bank also operates two subsidiaries: First Charter Insurance Services, Inc. (First Charter Insurance) and First Charter Leasing and Investments, Inc (First Charter Leasing). First Charter Insurance is a North Carolina corporation formed to meet the insurance needs of businesses and individuals. First Charter Leasing is a North Carolina corporation which administers leases and manages investment securities. It also acts as the holding company for First Charter of Virginia Realty Investments,

Inc., a Virginia corporation (First Charter Virginia). First Charter Virginia is engaged in the mortgage origination business and also acts as the holding company for First Charter Realty Investments, Inc., a Delaware real estate investment trust (First Charter Realty). First Charter Realty is the holding company for FCB Real Estate, Inc., a North Carolina real estate investment trust, and First Charter Real Estate Holdings, LLC, a North Carolina limited liability company, which owns and maintains the real estate property and assets of the Corporation. FCB Real Estate, Inc. primarily invests in commercial and 1-4 family residential real estate loans. The Bank also has a majority ownership in Lincoln Center at Mallard Creek, LLC, a North Carolina limited liability company. Lincoln Center is a three-story office building occupied in part by First Charter Insurance Services and a branch of the Bank.

At December 31, 2005, the Corporation and its subsidiaries had 1,064 full-time equivalent employees. The Corporation had no employees who were not also employees of The Bank. The Corporation considers its relations with its employees to be good.

As part of its operations, the Corporation is not dependent upon a single customer or a few customers whose loss would have a material adverse effect on the Corporation.

As part of its operations, the Corporation regularly holds discussions and evaluates the potential acquisition of, or merger with, various financial institutions. In addition, the Corporation periodically enters new markets and engages in new activities in which it competes with established financial institutions. There can be no assurance as to the success of any such new office or activity. Furthermore, as the result of such expansions, the Corporation may from time to time incur start-up costs that could affect its financial results.

The Corporation operates one reportable segment, the Bank. See ***Note Two*** of the consolidated financial statements.

Competition

Banking activities in North Carolina are highly competitive. The banking laws of North Carolina allow banks located in North Carolina to develop branches throughout the state. In addition, out-of-state institutions may open de novo branches in North Carolina as well as acquire or merge with institutions located in North Carolina.

The Corporation has active competition in all areas in which it presently engages in business. Within these areas are numerous branches of national, regional, and local institutions. In its market area, the Corporation faces competition from other banks, including three of the largest banks in the country, savings and loan associations, savings banks, credit unions, finance companies, brokerage firms, insurance companies and major retail stores that offer competing financial services. Many of these competitors have greater resources, broader geographic coverage and higher lending limits than the Bank. The Bank s primary method of competition is to provide our clients with a broad array of financial products and solutions, delivered with exceptional service and convenience at a fair price.

Government Supervision and Regulation

General. As a registered bank holding company, the Corporation is subject to the supervision of and regular inspection by, the Board of Governors of the Federal Reserve System (the Federal Reserve). The Bank is a North Carolina chartered banking corporation and a Federal Reserve member bank, with deposits insured by the Federal Deposit Insurance Corporation s (FDIC). The Bank is subject to extensive regulation and examination by the Federal Reserve, the Office of the Commissioner of Banks of the State of North Carolina (the NC Commissioner) under the direction and supervision of the North Carolina Banking Commission (the NC Banking Commission) and by the FDIC, which insures its deposits to the maximum extent permitted by law.

The federal and state laws and regulations applicable to the Bank deal with required reserves against deposits, allowable investments, loans, mergers, consolidations, issuance of securities, payment of dividends, establishment of branches, limitations on credit to subsidiaries and other aspects of the

business of such subsidiaries. The federal and state banking agencies have broad authority and discretion in connection with their supervisory and enforcement activities and examination policies, including policies involving the classification of assets and the establishment of loan loss reserves for regulatory purposes. Such actions by the regulators prohibit member banks from engaging in unsafe or unsound banking practices. The Bank is also subject to certain reserve requirements established by the Federal Reserve Board and is a member of the Federal Home Loan Bank (FHLB) of Atlanta, which is one of the 12 regional banks comprising the FHLB System.

In addition to state and federal banking laws, regulations and regulatory agencies, the Corporation and the Bank are subject to various other laws, regulation, and supervision and examination by other regulatory agencies, all of which directly or indirectly affect the Corporation s operations, management and ability to make distributions. The following discussion summarizes certain aspects of those laws and regulations that affect the Corporation.

Gramm-Leach-Bliley Financial Modernization Act of 1999. The Gramm-Leach-Bliley Financial Modernization Act of 1999 (the GLB Act) eliminated certain legal barriers separating the conduct of various types of financial service businesses, such as commercial banking, investment banking and insurance in addition to substantially revamping the regulatory scheme within which the Corporation operates. Under the GLB Act, bank holding companies meeting management, capital and Community Reinvestment Act standards, and that have elected to become a financial holding company, may engage in a substantially broader range of traditionally nonbanking activities than was permissible before enactment, including insurance underwriting and making merchant banking investments in commercial and financial companies. The Corporation has not elected to become a financial holding company. The GLB Act also allows insurers and other financial services companies to acquire banks, removes various restrictions that currently apply to bank holding company ownership of securities firms and mutual fund advisory companies, and establishes the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations.

In addition, the GLB Act also modified the law related to financial privacy and community reinvestment. The privacy provisions generally prohibit financial institutions from disclosing nonpublic personal financial information to nonaffiliated third parties unless the customer has the opportunity to opt out of the sharing of the customer s nonpublic information with unaffiliated third parties.

Restrictions on Bank Holding Companies. The Federal Reserve is authorized to adopt regulation affecting various aspects of bank holding companies. Under the BHCA, the Corporation s activities and those of companies that it controls or holds more than five percent of the voting stock, are limited to certain activities including banking, managing or controlling banks furnishing or performing services for subsidiaries, or any other activity which the Federal Reserve determines to be so closely related to banking, managing or controlling banks that it is also considered a covered activity. In making those determinations, the Federal Reserve is required to consider whether the performance of such activities by a bank holding company or its subsidiaries can be expected to reasonably produce benefits to the public such as greater convenience, increased competition or gains in efficiency that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The BHCA, as amended by the GLB Act, generally limits the activities of a bank holding company (unless the bank holding company has elected to become a financial holding company) to activities that are closely related to banking and a proper incident thereto.

Generally, bank holding companies are required to obtain prior approval of the Federal Reserve to engage in any new activity not previously approved by the Federal Reserve or when acquiring more than five percent of any class of voting stock of any company. The BHCA also requires bank holding companies to obtain the prior approval of the Federal Reserve before acquiring more than five percent of any class of voting stock of any bank which is not already majority-owned by the bank holding company.

The Corporation is also subject to the North Carolina Bank Holding Company Act of 1984. This state legislation requires the Corporation, by virtue of its ownership of the Bank, to register as a bank holding company with the NC Commissioner.

Interstate Banking and Branching Legislation. Pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Banking and Branching Act), a bank holding company may acquire banks in states other than its home state, without regard to the permissibility of those acquisitions under state law, but subject to any state requirement that the bank has been organized and operating for a minimum period of time, not to exceed five years, and other conditions, including concentration limits.

The Interstate Banking and Branching Act also authorized banks to merge across state lines, thereby creating interstate branches. Under this legislation, each state had the opportunity either to opt out of this provision, thereby prohibiting interstate branching in such states, or to opt in . The State of North Carolina elected to opt in to such legislation. Furthermore, pursuant to the Interstate Banking and Branching Act, a bank is now able to open new branches in a state in which it does not already have banking operations, if the laws of such state permit such de novo branching.

Consumer Protection. In connection with its lending and leasing activities, the Bank and its subsidiaries are subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy and population. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, and the Real Estate Settlement Procedures Act, as well as state law counterparts.

Title V of the GLB Act, along with other provisions of federal law, currently contain extensive consumer privacy protection provisions. Under these provisions, a financial institution must provide it s customers at the inception of the customer relationship and annually thereafter, the financial institution s policies and procedures for collecting, disclosing, and protecting nonpublic personal financial information. These provisions also provide that, except for certain limited exceptions, a financial institution may not provide nonpublic personal information to nonaffiliated third parties unless the financial institution discloses to the customer that the information may be provided and the customer is given the opportunity to opt out of that disclosure. Federal law makes it a criminal offense, except in limited circumstances, to obtain or attempt to obtain customer information of a financial nature by fraudulent or deceptive means.

The Community Reinvestment Act of 1977 requires the Bank s primary federal regulatory agency, in this case, the Federal Reserve, to assess First Charter s ability to meet the credit needs of low- and moderate-income persons. Financial institutions are assigned one of four ratings: Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance. On December 31, 2005, the Bank s rating was Satisfactory .

The USA PATRIOT Act. After the September 11, 2001 terrorist attacks in New York and Washington, D.C., the United States government attempted to tighten control on activities perceived to be connected to money laundering and terrorist funding. A series of orders were issued which attempt to identify terrorists and terrorist organizations and require the blocking of property and assets of, as well as prohibiting all transactions or dealings with, such terrorists, terrorist organizations and those that assist or sponsor them. The USA Patriot Act substantially broadened existing anti-money laundering legislation and the extraterritorial jurisdiction of the United States, imposed new compliance and due diligence obligations, created new crimes and penalties, compelled the production of documents located both inside and outside the United States, including those of foreign institutions that have a correspondent relationship in the United States, and clarified the safe harbor from civil liability to customers. In addition, the United States Treasury Department issued regulations in cooperation with the federal banking agencies, the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Department of Justice that require customer identification and verification, expand the money-laundering program requirement to the major financial services sectors including insurance and unregistered investment companies such as hedge funds, and facilitate and permit the sharing of information between law enforcement and financial institutions and among financial institutions. The United States Treasury Department also has created the Treasury USA PATRIOT Act Task Force to work with other financial regulators, the regulated community, law enforcement and consumers to continually improve regulation.

Sarbanes-Oxley Act of 2002. On July 30, 2002, the Sarbanes-Oxley Act was enacted which addressed corporate governance and securities reporting requirements. Among its requirements are

changes in auditing and accounting, executive compensation and certifications by Chief Executive Officers and Chief Financial Officers of certain securities filings. It also expanded reporting of information in current reports filed with the Securities and Exchange Commission and required more detailed reporting information in securities disclosure documents in a more timely manner. The NASDAQ National Market has also modified its corporate governance rules with an intent to allow shareholders to more easily and efficiently monitor the performance and activities of companies and their executive officers and directors.

Capital and Operational Requirements

The Corporation and the Bank must comply with the minimum capital adequacy standards set by the Federal Reserve and the FDIC which are substantially similar. The risk-based guidelines define a three-tier capital framework, under which the Corporation and the Bank are required to maintain a minimum ratio of Tier 1 Capital (as defined) to total risk-weighted assets of 4.00 percent and a minimum ratio of Total Capital (as defined) to risk-weighted assets of 8.00 percent. Tier 1 capital includes common shareholders equity, trust preferred securities, minority interests and qualifying preferred stock, less goodwill and other adjustments. Tier 2 Capital includes, among other items, cumulative perpetual preferred stock, long-term preferred stock, hybrid capital instruments, qualifying subordinated debt, and the allowance for credit losses up to 1.25 percent of risk-weighted assets. Tier 3 capital includes subordinated debt that is unsecured, fully paid, has an original maturity of at least two years, is not redeemable before maturity without prior approval of the Federal Reserve and includes a lock-in clause precluding payment of either interest or principal if the payment would cause the issuing bank s risk-based capital ratio to fall or remain below the required minimum. The sum of Tier 1 and Tier 2 Capital less investments in unconsolidated subsidiaries is equal to qualifying total capital. Risk-based capital ratios are calculated by dividing Tier 1 and Total Capital by risk-weighted assets. Risk-weighted assets refer to the on- and off-balance sheet exposures of the Corporation and the Bank, as adjusted for one of four categories of applicable risk-weights established in Federal Reserve regulations, based primarily on relative credit risk. At December 31, 2005, the Corporation and the Bank were in compliance with the risk-based capital requirements. The Corporation s Tier 1 and Total Capital Ratios at December 31, 2005 were 11.20 percent and 12.06 percent, respectively. The Corporation did not have any subordinated debt that qualified as Tier 3 Capital at December 31, 2005. The leverage ratio is calculated by dividing Tier 1 Capital by adjusted total assets. The Corporation s leverage ratio at December 31, 2005 was 8.67 percent. The Corporation meets its leverage ratio requirement.

In addition to the above described capital requirements, the federal regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels due to the organizations financial condition or actual or anticipated growth.

Prompt Corrective Action under FDICIA. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. In addition, pursuant to FDICIA, the various regulatory agencies have prescribed certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation, and such agencies may take action against a financial institution that does not meet the applicable standards.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the Total Risk-Based Capital, Tier 1 Risk-Based Capital and Leverage Capital Ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have (i) a Tier 1 Capital ratio of at least 6.00 percent, (ii) a Total Capital ratio of at least 10.00 percent, (iii) a Leverage ratio of at least 5.00 percent and (iv) not be subject to a capital directive order. An adequately capitalized institution must have a Tier 1 Capital ratio of at least

7

4.00 percent, a Total Capital ratio of at least 8.00 percent and a leverage ratio of at least 4.00 percent, or 3.00 percent in some cases. Under these guidelines, the Bank is considered well capitalized as of December 31, 2005. See ***Note Twenty*** of the consolidated financial statements.

Banking agencies have also adopted regulations which mandate that regulators take into consideration (i) concentrations of credit risk, (ii) interest rate risk and (iii) risks from non-traditional activities, as well as an institution s ability to manage those risks, when determining the adequacy of an institution s capital. This evaluation is made as a part of the institution s regular safety and soundness examination. In addition, the banking agencies have amended their regulatory capital guidelines to incorporate a measure for market risk. In accordance with amended guidelines, a corporation or bank with significant trading activity (as defined in the amendment) must incorporate a measure for market risk in its regulatory capital calculations. The revised guidelines do not materially impact the Corporation s or the Bank s regulatory capital ratios or the Bank s well-capitalized status.

Distributions. The Corporation is a legal entity separate and distinct from its subsidiaries. The primary source of funds for distributions paid by the Corporation to its shareholders is dividends received from the Bank. Federal regulatory and other requirements, as well as laws and regulations of the State of North Carolina, restrict the lending of funds by the Bank to the Corporation and the amount of dividends that the Bank can pay to the Corporation. The Federal Reserve regulates the amount of the Bank dividends payable to the Corporation based on net profits for the current year combined with the undivided profits for the last two years, less dividends already paid. See ***Note Twenty*** of the consolidated financial statements. North Carolina laws provide that, subject to certain capital requirements, a board of directors of a North Carolina Bank may declare a dividend of as much of the bank s undivided profits as it deems expedient.

In addition to the foregoing, the ability of the Corporation and the Bank to pay dividends may be affected by the various minimum capital requirements and the capital and non-capital standards established under FDICIA, as described above. Furthermore, if in the opinion of a federal regulatory agency, a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), such agency may require, after notice and hearing, that such bank cease and desist from such practice. The right of the Corporation, its shareholders and its creditors to participate in any distribution of assets or earnings of the Bank is further subject to the prior claims of creditors against the Bank.

Deposit Insurance. The deposits of the Bank are insured up to applicable limits by the FDIC. As insurer, the FDIC is authorized to conduct examinations of, and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the FDIC. The FDIC also has the authority to initiate enforcement actions against banking institutions, after giving the institution s primary regulator an opportunity to take such action. In addition, the Bank is subject to deposit premium assessments by the FDIC. As mandated by FDICIA, the FDIC has adopted regulations for a risk-based insurance assessment system. Under this system, the assessment rates for an insured depository institution vary according to the level of risk incurred in its activities. To arrive at a risk assessment for a banking institution, the FDIC places it in one of nine risk categories using a process based on capital ratios and on other relevant information from supervisory evaluations of the bank by the bank s primary federal regulator, the Federal Reserve, statistical analyses of financial statements and other relevant information.

The deposits of the Bank are insured by the Bank Insurance Fund (the BIF), administered by the FDIC. Under the FDIC s risk-based insurance system, assessments for BIF members currently can range from no assessment to an assessment of 27 basis points per $100 of insured deposits, with the exact assessment determined by a bank s capital and other regulatory factors. The range of deposit insurance assessment rates can change from time to time, in the discretion of the FDIC, subject to certain limits. At this time, the amount of any future premiums required to be paid by the Bank is not known.

Source of Strength. According to Federal Reserve policy, bank holding companies are expected to act as a source of financial strength to subsidiary banks and to commit resources to support each such subsidiary. This support may be required at times when a bank holding company may not be able to provide such support. Similarly, under the cross-guaranty provisions of the Federal Deposit Insurance Act,

in the event of a loss suffered or anticipated by the FDIC, either as a result of default of a banking or thrift subsidiary of the Corporation or related to FDIC assistance provided to a subsidiary in danger of default, the other banking subsidiaries of the Registrant may be assessed for the FDIC s loss, subject to certain exceptions.

Future Legislation. Proposals to change the laws and regulations governing the banking industry are frequently introduced in Congress, in the state legislatures and before the various bank regulatory agencies. The likelihood and timing of any such proposals or bills being enacted and the impact they might have on the Corporation and the Bank cannot be determined at this time.

Regulatory Recommendations. Management is not presently aware of any current recommendations to the Corporation or to the Bank by regulatory authorities, which, if they were to be implemented, would have a material effect on the Corporation s liquidity, capital resources, or operations.

Other Considerations

There are particular risks and uncertainties that are applicable to an investment in the Corporation s common stock. Specifically, there are risks and uncertainties that bear on the Corporation s future financial results that may cause its future earnings and financial condition to be less than its expectations. Some of these risks and uncertainties relate to economic conditions generally and would affect other financial institutions in similar ways. See **Risk Factors** and Factors that May Affect Future Results in the accompanying Management s Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the particular risks and uncertainties that are specific to the Corporation s business.

Available Information

The Corporation s Internet address is http://www.firstcharter.com. The Corporation makes available, free of charge, on or through its website, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13 (a) or 15 (d) of the Securities Exchange Act of 1934, and beneficial ownership reports on Forms 3, 4 and 5, as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the Securities Exchange Commission. The Corporation s website also includes the charters of its Audit Committee, Compensation Committee and Governance and Nominating Committee, its Code of Business Conduct and Ethics applicable to its directors and employees (including its Chief Executive Officer and Chief Financial Officer) and those of its subsidiaries, and its Corporate Governance Guidelines.

Item 1A. *Risk Factors*

An investment in the Corporation s common stock is subject to risks inherent to the Corporation s business. The material risks and uncertainties that management believes affect the Corporation are described below. Before making an investment decision, you should carefully consider these risks and uncertainties, together with all of the other information included or incorporated by reference in this report. These risks and uncertainties are not the only ones facing the Corporation. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Corporation s business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, the Corporation s financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of the Corporation s common stock could decline significantly, and you could lose all or part of your investment.

Risks Related To The Corporation s Business

The Corporation Is Subject To Interest Rate Risk.

The Corporation s earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed

funds. Interest rates are highly sensitive to many factors that are beyond the Corporation s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Corporation receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Corporation s ability to originate loans and obtain deposits, (ii) the fair value of the Corporation s financial assets and liabilities, and (iii) the average duration of the Corporation s mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Corporation s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset-liability management strategies, including the potential use of derivatives as hedging instruments, to reduce the potential effects of changes in interest rates on the Corporation s results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Corporation s financial condition and results of operations. See Market Risk Management Asset-Liability and Interest Rate Risk in the accompanying Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation s management of interest rate risk.

The Corporation Is Subject To Lending Risk.

There are inherent risks associated with the Corporation s lending activities. There risks include, among other things, the impact of changes in interest rates and changes in the economic conditions of the markets where the Corporation operates as well as those across the State of North Carolina and the United States. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. The Corporation is also subject to various laws and regulations that affect its lending activities. Failure to comply with applicable laws and regulations could subject the Corporation to regulatory enforcement action that could result in the assessment of significant civil money penalties.

As of December 31, 2005, approximately 52 percent of the Corporation s loan portfolio consisted of commercial non-real estate, construction and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Corporation s loan portfolio contains a significant number of commercial non-real estate, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in nonperforming loans could result in a net loss of earnings from these loans, an increase in a provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Corporation s financial condition and results of operations. See Balance Sheet Analysis - Loan Portfolio in the accompanying Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation s loan portfolio.

The Corporation s Allowance For Loan Losses May Be Insufficient.

The Corporation maintains an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense that represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management s continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and

requires management to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Corporation s control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review the Corporation s allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, the Corporation will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on the Corporation s financial condition and results of operations. See Credit Risk Management - Allowance for Loan Losses in the accompanying Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Corporation s process for determining the appropriate level of the allowance for possible loan losses.

The Corporation Is Subject To Environmental Liability Risk Associated With Lending Activities.

A significant portion of the Corporation s loan portfolio is secured by real property. During the ordinary course of business, the Corporation may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Corporation may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Corporation to incur substantial expenses and may materially reduce the affected property s value or limit the Corporation s ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Corporation s exposure to environmental liability. Although the Corporation has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation s Profitability Depends Significantly On Economic Conditions In The Carolinas.

The Corporation s success depends primarily on the general economic conditions of the Carolinas and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers primarily in the metropolitan areas of Charlotte-Gastonia-Concord, Lincolnton, Statesville-Mooresville, Shelby, Forest City, Salisbury, Asheville, Brevard and Raleigh-Cary. The local economic conditions in these areas have a significant impact on the demand for the Corporation s products and services as well as the ability of the Corporation s customers to repay loans, the value of the collateral securing loans and the stability of the Corporation s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, or unemployment in the Corporation s primary markets, or changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation Operates In A Highly Competitive Industry and Market Area.

The Corporation faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources than the Corporation. Such competitors primarily include national, regional and local financial institutions within the various markets the Corporation operates. Additionally, various out-of-state banks have begun to enter or have announced plans to enter the market areas in which the Corporation currently operates. The Corporation also faces competition from many other types of financial institutions, including, without limitation, savings and loan associations, savings banks, credit unions, finance companies, brokerage firms, insurance companies, and major retail stores that offer competing financial services. The financial services industry could

become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of the Corporation s competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Corporation can.

The Corporation s ability to compete successfully depends on a number of factors, including, among other things:

The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.

The ability to expand the Corporation s market position.

The scope, relevance and pricing of products and services offered to meet customer needs and demands.

The rate at which the Corporation introduces new products and services relative to its competitors.

Customer satisfaction with the Corporation s level of service.

Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Corporation s competitive position, which could adversely affect the Corporation s growth and profitability, which, in turn, could have a material adverse effect on the Corporation s financial condition and results of operation.

The Corporation Is Subject To Extensive Government Regulation and Supervision.

The Corporation, primarily through the Bank and certain non-bank subsidiaries, is subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect the Corporation s lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Corporation in substantial and unpredictable ways. Such changes could subject the Corporation to additional costs, limit the types of financial services and products the Corporation may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Corporation s business, financial condition and results of operations. While the Corporation has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. See Government Supervision and Regulation in the accompanying Business section and ***Note Twenty*** of the consolidated financial statements.

The Corporation s Controls and Procedures May Fail or Be Circumvented.

Management regularly reviews and updates the Corporation s internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however

well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the systems are met. Any failure or circumvention of the Corporation s controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Corporation s business, results of operations and financial condition.

New Lines of Business or New Products and Services May Subject The Corporation to Additional Risks.

From time to time, the Corporation may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services the Corporation may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Corporation s system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Corporation s business, results of operations and financial condition.

The Corporation Relies On Dividends From the Bank For Most Of Its Revenue.

First Charter Corporation is a separate and distinct legal entity from the Bank. It receives substantially all of its revenue from dividends received from the Bank. These dividends are the principal source of funds to pay dividends on the Corporation s common stock and interest and principal on its outstanding debt securities. Various federal and/or state laws and regulations limit the amount of dividends that the Bank may pay to the Corporation. In the event the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to service debt, pay obligations or pay dividends on the Corporation s common stock. The inability to receive dividends from the Bank could have a material adverse effect on the Corporation s business, financial condition, and results of operations. See Government Supervision and Regulation in the accompanying Business section and ***Note Twenty*** of the consolidated financial statements.

Potential Acquisitions May Disrupt The Corporation s Business and Dilute Shareholder Value.

From time to time the Corporation may seek merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale or expanded services. Acquiring other banks, businesses, or branches involves risks commonly associated with acquisitions, including, among other things:

- Potential exposure to unknown or contingent liabilities of the target company.
- Exposure to potential asset quality issues of the target company.
- Difficulty and expense of integrating the operations and personnel of the target company.
- Potential disruption to the Corporation s business.
- Potential diversion of the time and attention of the Corporation s management.
- The possible loss of key employees and customers of the target company.
- Difficulty in estimating the value of the target company.

Potential changes in banking or tax laws or regulations that may affect the target company.

The Corporation regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur at any time. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of the Corporation s tangible book value and net income per common share may occur in connection with any future transaction. Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from an acquisition could have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation May Not Be Able To Attract and Retain Skilled Personnel.

The Corporation s success depends, in large part, on its ability to attract and retain key personnel. Competition for these individuals in most businesses engaged in by the Corporation can be intense and the Corporation may not be able to hire or retain them. The unexpected loss of services of one or more of the Corporation s key personnel could have a material adverse impact on the Corporation s business because of their skills, knowledge of the Corporation s market, years of financial services experience and the difficulty of promptly finding qualified replacement personnel. The Corporation has employment agreements or non-competition agreements with several of its senior and executive officers in an attempt to partially mitigate this risk.

The Corporation s Information Systems May Experience An Interruption Or Breach In Security.

The Corporation relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Corporation s customer relationship management, general ledger, deposit, loan and other systems. While the Corporation has policies and procedures designed to prevent or limit the effect of the failure, interruptions or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of the Corporation s information systems could damage the Corporation s reputation, result in a loss of customer business, subject the Corporation to additional regulatory scrutiny, or expose the Corporation to civil litigation and possible financial liability, any of which could have a material adverse effect on the Corporation s financial condition and results of operations.

The Corporation Continually Encounters Technological Advancements.

The financial services industry is continually undergoing rapid technological advancements with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Corporation s future success depends, in large part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Corporation s operations. Many of the Corporation s competitors have substantially greater resources to invest in technological improvements. The Corporation may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological advancements affecting the financial services industry could have a material adverse impact on the Corporation s business and, in turn, the Corporation s financial condition and results of operations.

The Corporation Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility.

From time to time, customers make claims and take legal action pertaining to the Corporation s performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Corporation s performance of its fiduciary responsibilities are founded or unfounded, if such claims and

legal actions are not resolved in a manner favorable to the Corporation they may result in significant financial liability and/or adversely affect the market perception of the Corporation and its products and services as well as impact customer demand for those products and services. Any financial liability or reputational damage could have a material adverse effect on the Corporation s business, which, in turn, could have a material adverse effect o the Corporation s financial condition and results of operations.

The Corporation May Need Additional Capital Resources In The Future Which May Not Be Available When Needed Or At All.

The Corporation may need to obtain additional debt or equity financing in the future for growth, investment or strategic acquisitions. There can be no assurance that such financing will be available to the Corporation on acceptable terms or at all. If the Corporation is unable to obtain such additional financing, the Corporation may not be able to grow or make strategic acquisitions or investments when desired, which could have a material adverse impact on the Corporation s business and, in turn, the Corporation s financial condition and results of operations.

Severe Weather, Natural Disasters and Other Adverse External Events Could Significantly Impact The Corporation s Business.

Severe weather, natural disasters and other adverse external events could have a significant impact on the Corporation s ability to conduct business. Such events could affect the stability of the Corporation s deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and or cause the Corporation to incur additional expenses. The Southeast region of the Untied States is periodically impacted by hurricanes. For example, during 1989, Hurricane Hugo made landfall along the South Carolina coast and subsequently caused extensive flooding and destruction in the metropolitan area of Charlotte, North Carolina and other communities where the Corporation conducts business. While the impact of hurricanes may not significantly affect the Corporation, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Corporation s business, which, in turn, could have a material adverse effect on the Corporation s financial condition and results of operations.

Risks Associated With The Corporation s Common Stock

The Corporation s Stock Price Can Be Volatile.

Stock price volatility may make it more difficult for a shareholder to resell the Corporation s common stock when desired and at favorable prices. The Corporation s stock price can fluctuate significantly in response to a variety of factors including, among other things:

Actual or anticipated variations in quarterly results of operations.

Recommendations by securities analysts.

Operating and stock price performance of other financial institutions that investors deem comparable to the Corporation.

News reports relating to trends, concerns and other issues in the financial services industry.

Perceptions in the marketplace regarding the Corporation and/or its competitors.

New technology used, or services offered, by competitors.

Significant acquisitions, business combinations or capital commitments by or involving the Corporation or its competitors.

Failure to integrate acquisitions or realize anticipated benefits from acquisitions.

Changes in government regulations.

Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause the Corporation s stock price to decrease regardless of operating results.

The Trading Volume In The Corporation s Common Stock Is Less Than That Of Other Larger Financial Services Companies.

Although the Corporation s common stock is listed for trading on the NASDAQ National Market, the trading volume in its common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation s common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation s common stock, significant sales of the Corporation s common stock, or the expectation of these sales, could cause the Corporation s stock price to fall.

An Investment In The Corporation s Common Stock Is Not An Insured Deposit.

The Corporation s common stock is not a bank deposit and, therefore, is not insured against loss by the Federal Deposit Insurance Corporation (FDIC), any other deposit insurance fund or by any other public or private entity. Investment in the Corporation s common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Corporation s common stock, you may lose some or all of your investment.

The Corporation s Articles Of Incorporation, Bylaws and Stockholder Protection Rights Agreement As Well As Certain Banking Laws May Have An Anti-Takeover Effect.

Provisions of the Corporation s articles of incorporation and bylaws, federal banking laws, including regulatory approval requirements, and the Corporation s Stockholder Protection Rights Agreement could make it more difficult for a third party to acquire the Corporation, even if doing so would be perceived to be beneficial to the Corporation s shareholders. The combination of these provisions effectively inhibits a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Corporation s common stock.

Risks Associated With The Corporation s Industry

The Earnings Of Financial Services Companies Are Significantly Affected By General Business And Economic Conditions.

The Corporation s operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U. S. economy and the local economies in which the Corporation operates, all of which are beyond the Corporation s control. A deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for the Corporation s products and services, among other things, any of which could have a material adverse impact on the Corporation s financial condition and results of operations.

Financial Services Companies Depend On The Accuracy And Completeness Of Information About Customers And Counterparties.

In deciding whether to extend credit or enter into other transactions, the Corporation may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Corporation may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on the Corporation s business and, in turn, the Corporation s financial condition and results of operations.

Consumers May Decide Not To Use Banks To Complete Their Financial Transactions.

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on the Corporation s financial condition and results of operations.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

The principal offices of the Corporation are located in the First Charter Center located at 10200 David Taylor Drive in Charlotte, North Carolina, which is owned by the Bank through its subsidiaries. The First Charter Center contains the corporate offices of the Corporation as well as the operations, mortgage loan and data processing departments of the Bank.

At December 31, 2005, the Bank had 55 financial centers, four insurance offices and 137 ATMs located throughout North Carolina. As of December 31, 2005, the Corporation and its subsidiaries owned 36 financial center locations and leased 19 financial center locations and its four insurance offices. The Corporation also leases a facility in Reston, Virginia for the origination of real estate loans. In addition, the Corporation leases a facility in Winston-Salem, North Carolina for the operations of its third party benefits administrator.

Item 3. *Legal Proceedings*

The Corporation and the Bank are defendants in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated operations, liquidity or financial position of the Corporation or the Bank.

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

There were no matters submitted to a vote of shareholders during the quarter ended December 31, 2005.

Item 4A. ***Executive Officers of the Registrant***

The following table sets forth certain information about each of the current executive officers of the Registrant, including his name, age, positions and offices held with the Registrant and the Bank, the period served in such positions or offices and, if such person has served in such position and office for less than five years, the prior employment of such person. No executive officer has a family relationship as close as first cousin with any other executive officer or director.

Name	Age	Office and Position	Year Position Held	
Robert E. James, Jr.	55	President and Chief Executive Officer of the Registrant	2005	Present
		President and Chief Executive Officer of the Bank	2004	Present
		Executive Vice President of the Registrant	1999	2005
		Executive Vice President of the Bank	1999	2004
Charles A. Caswell	43	Executive Vice President, Chief Financial Officer and Treasurer of the Registrant and the Bank	2005	Present
		Executive Vice President and Chief Financial Officer of Integra Bank Corporation	2002	2005
		Chief Financial Officer of RBC Centura Banks, Inc.	2001	2002
		Treasurer of RBC Centura Banks, Inc.	1997	2001
Richard A. Manley	50	Executive Vice President and Chief Banking Officer of the Registrant	2005	Present
		Executive Vice President and Chief Banking Officer of the Bank	2003	Present
		Senior Vice President and Chief Banking Officer of the Bank	1999	2003
Stephen M. Rownd	46	Executive Vice President and Chief Risk Officer of the Registrant and the Bank	2004	Present
		Executive Vice President and Chief Credit Officer of the Registrant and the Bank	2000	2004
Cecil O. Smith, Jr.	58	Executive Vice President and Chief Information Officer of the Registrant and the Bank	2005	Present
		Vice President, Duke Energy Business Solutions	2004	2005
		Senior Vice President and Chief Information Officer, Duke Energy Corporation	1995	2004
Stephen J. Antal	50	Senior Vice President, General Counsel and Corporate Secretary of the Registrant and the Bank	2005	Present
		Member, Womble, Carlyle, Sandridge and Rice, PLLC	2002	2005
		Senior Vice President and Assistant General Counsel, Wachovia Corporation (formerly First Union Corporation)	1996	2002

PART II

Item 5. ***Market For Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Market Information, Holders and Dividends

The principal market on which the Corporation s common stock (the Common Stock) is traded is the NASDAQ National Market. The following table sets forth the high and low sales prices of the Common Stock for the periods indicated, as reported on the NASDAQ National Market:

	Quarter	High	Low
2004	first	21.68	19.52
	second	21.89	20.05
	third	24.50	20.86
	fourth	28.11	25.00
2005	first	25.74	22.33
	second	23.34	20.85
	third	25.73	22.25
	fourth	26.66	22.34

As of March 8, 2006, there were 7,162 record holders of the Common Stock. During 2004 and 2005, the Corporation paid dividends on the Common Stock on a quarterly basis. The following table sets forth dividends declared per share of Common Stock for the periods indicated:

	Quarter	Dividend
2004	first	0.185
	second	0.185
	third	0.190
	fourth	0.190
2005	first	0.190
	second	0.190
	third	0.190
	fourth	0.190

For additional information regarding the Corporation s ability to pay dividends, see **Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Management**.

Equity Compensation Plan Information

The following table provides information as of December 31, 2005 regarding the number of shares of the Common Stock that may be issued under the Corporation s equity compensation plans.

As of December 31, 2005

Plan category:	Number of securities to be issued upon exercise of outstanding options, warrants and rights [1]	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders [2]	1,754,733	$ 19.21	2,057,548
Equity compensation plans not approved by security holders			
Total	1,754,733	$ 19.21	2,057,548

(1) The table does not include outstanding options to purchase 915,972 shares of Common Stock assumed through various mergers and acquisitions. As of December 31, 2005, these assumed options had a weighted average exercise price of $23.95 per share.

(2) The table includes 32,647 restricted shares of Common Stock which are not yet vested and were granted pursuant to the

Corporation s Restricted Stock Award Program, which was approved by shareholders. 302,200 shares remain available for grant pursuant to such plan.

Recent Sales of Unregistered Securities

On December 1, 2004, the Corporation, through First Charter Bank, its primary banking subsidiary, acquired substantially all of the assets of Smith & Associates Insurance Services, Inc., a property and casualty insurance agency (the Agency), pursuant to an Asset Purchase Agreement, dated as of the same date (the Purchase Agreement). No underwriters were used in connection with this transaction. In connection with this transaction, the Corporation issued an aggregate of 27,726 shares of Common Stock valued at $750,000 to the Agency. In addition, on May 2, 2005, the Corporation issued 3,117 shares of Common Stock valued at $84,000 in connection with this acquisition. The issuance of the shares in connection with this transaction was exempt from the registration requirements of the Securities Act of 1933, as amended, in accordance with Section 4(2) thereof, as a transaction by an issuer not involving a public offering. The Purchase Agreement also contemplates additional, subsequent issuances of Common Stock based upon the future performance of the Agency. The Corporation presently expects the value of future issuances, if earned, to total approximately $980,000.

On July 7, 2003, the Corporation, through First Charter Bank, its primary banking subsidiary, acquired a third party benefits administrator in a stock purchase. No underwriters were used in connection with this transaction. In connection with this transaction, the Corporation issued an aggregate of 78,441 shares of Common Stock valued at $1.32 million to the third party benefits administrator and the agreement contemplated additional Common Stock payments based on the post-closing performance of the business. Based on this agreement and the performance of the business, on September 1, 2004 the Corporation issued 20,244 additional shares of Common Stock valued at $425,000 for the period of July 1, 2003 through June 30, 2004. On October 26, 2005, the Corporation issued 18,160 additional shares of Common Stock valued at $416,000 for the period of July 1, 2004 through June 30, 2005. The issuance of the shares in connection with this transaction was exempt from the registration requirements of the Securities Act of 1933, as amended, in accordance with Section 4(2) thereof, as a transaction by an issuer not involving a public offering. There will be no additional subsequent issuances of Common Stock related to this transaction.

Issuer Purchases of Equity Securities

The following table summarizes the Corporation s repurchases of Common Stock during the quarter ended December 31, 2005.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2005 October 31, 2005				1,625,400
November 1, 2005 November 30, 2005				1,625,400
December 1, 2005 December 31, 2005				1,625,400
Total				1,625,400

(1) On January 24, 2002, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to 1,500,000 shares of the Corporation s common stock from time to time. As of December 31, 2005, the Corporation had repurchased 1,374,600 shares under this authorization. No shares were repurchased under this

authorization during the quarter ended December 31, 2005. On November 3, 2003, the Corporation announced that its Board of Directors had authorized a stock repurchase plan to acquire up to an additional 1,500,000 shares of the Corporation s common stock from time to time. As of December 31, 2005, no shares have been repurchased under this authorization. These stock repurchase plans have no set expiration or termination date.

Item 6. ***Selected Financial Data***

See ***Table One*** in Item 7 for Selected Financial Data.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis should be read in conjunction with the consolidated financial statements of the Corporation and the notes thereto.

Factors that May Affect Future Results

The following discussion contains certain forward-looking statements about the Corporation s financial condition and results of operations, which are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management s judgment only as of the date hereof. The Corporation undertakes no obligation to publicly revise these forward-looking statements to reflect events and circumstances that arise after the date hereof.

Factors that may cause actual results to differ materially from those contemplated by such forward- looking statements, and which may be beyond the Corporation s control, include, among others, the following possibilities: (1) projected results in connection with management s implementation of, or changes in, the Corporation s business plan and strategic initiatives, including the balance sheet initiatives described herein, are lower than expected; (2) competitive pressure among financial services companies increases significantly; (3) costs or difficulties related to the integration of acquisitions, including deposit attrition, customer retention and revenue loss, or expenses in general are greater than expected; (4) general economic conditions, in the markets in which the Corporation does business, are less favorable than expected; (5) risks inherent in making loans, including repayment risks and risks associated with collateral values, are greater than expected; (6) changes in the interest rate environment, or interest rate policies of the Board of Governors of the Federal Reserve System, may reduce interest margins and affect funding sources; (7) changes in market rates and prices may adversely affect the value of financial products; (8) legislation or regulatory requirements or changes thereto, including changes in accounting standards, may adversely affect the businesses in which the Corporation is engaged; (9) regulatory compliance cost increases are greater than expected; (10) the passage of future tax legislation, or any negative regulatory, administrative or judicial position, may adversely impact the Corporation; (11) the Corporation s competitors may have greater financial resources and may develop products that enable them to compete more successfully in the markets in which it operates; and (12) changes in the securities markets, including changes in interest rates, may adversely affect the Corporation s ability to raise capital from time to time.

Overview

First Charter Corporation is a regional financial services company with assets of $4.2 billion and is the holding company for First Charter Bank. As of December 31, 2005, First Charter operated 55 financial centers, four insurance offices and 137 ATMs located throughout North Carolina. First Charter also operates loan origination offices in Asheville, North Carolina and Reston, Virginia. First Charter provides businesses and individuals with a broad range of financial services, including banking, financial planning, wealth management, investments, insurance and mortgages.

The Corporation s principal source of earnings is derived from net interest income. Net interest income is the interest earned on securities, loans and other interest earning assets less the interest paid for deposits and long- and short-term debt.

Another source of earnings for the Corporation is noninterest income. Noninterest income is derived largely from service charges on deposit accounts and other fee or commission based services and products including mortgage, financial management, brokerage and insurance. Other sources of noninterest income include securities gains or losses, transactions involving bank-owned property and income from Bank Owned Life Insurance (BOLI) policies.

Noninterest expense is the primary component of expense for the Corporation. Noninterest expense is primarily composed of corporate operating expenses including salaries and benefits, occupancy and equipment, professional fees and other operating expenses. During 2005, several material transactions occurred which impacted noninterest expense including early termination of derivatives and their associated hedged debt instruments, early extinguishment of debt, the expense associated with the retirement of a key executive and the modification of a legacy employee benefit plan. Income taxes are also considered a material expense.

2005 Significant Events

A number of significant transition events occurred during 2005. First Charter installed a new executive management team. The new management team executed a balance sheet repositioning that included deleveraging the balance sheet by selling securities and extinguishing debt in an on-going effort to improve First Charter s earnings quality and stability, and other factors. The new management team also refined its growth strategy which resulted in First Charter s entry into the Raleigh market and a renewed focus on performance.

Executive Management Team Transition

On July 1, 2005, Robert E. James Jr. was elected President and Chief Executive Officer by the Corporation s Board of Directors. James has been with First Charter since 1999 and was elected President and Chief Executive Officer of the Bank in 2004. Charles A. Caswell joined First Charter in February 2005 as Executive Vice President, Chief Financial Officer and Treasurer. Cecil O. Smith joined First Charter in March 2005 as Executive Vice President and Chief Information Officer. Richard A. Manley was promoted to Executive Vice President and Chief Banking Officer in July 2005. Manley joined the company in 1999. Stephen M. Rownd continued as Executive Vice President and Chief Risk Officer, having joined First Charter in February 2000. Stephen J. Antal joined First Charter in March 2005 as Senior Vice President, General Counsel and Corporate Secretary.

Financial Initiatives

Management undertook several financial initiatives during the 2005 fiscal year. The balance sheet repositioning was the most significant. During the fourth quarter of 2005, the Corporation executed a series of initiatives to reposition and deleverage its balance sheet designed to improve the financial well being of the Corporation. The Corporation expects that these initiatives will improve the net interest margin and enhance its interest rate risk and liquidity risk profiles. In addition, these initiatives are expected to be accretive to earnings and thus improve the Corporation s earnings quality and capital ratios. As a result of executing these initiatives, the Corporation realized an approximate $31.3 million pre-tax ($20.0 million after-tax) charge in the fourth quarter of 2005. The repositioning included the following actions:

The Corporation sold approximately $466 million in fixed rate investment securities with an average book yield of 3.50 percent and an average life of 3.1 years. This resulted in a pre-tax loss on the sale of securities of approximately $16.7 million ($10.7 million after-tax).

The Corporation extinguished $222 million of its FHLB advances and related interest rate swaps with an average effective cost of 3-Month LIBOR plus 183 basis points, or 5.67 percent at the time of extinguishment. The remaining average life of the debt and swaps was approximately 4.2 years and maturities ranged from June 2006 to March 2011. The Corporation incurred a prepayment penalty of approximately $6.4 million pre-tax ($4.1 million after-tax) to extinguish these FHLB advances and incurred a loss of approximately $7.8 million pre-tax ($5.0 million after-tax) on the extinguishment of the related interest rate swaps.

The Corporation extinguished $25 million in FHLB advances with a fixed rate of 4.82 percent and a final maturity of June 2011. The Corporation incurred a prepayment penalty of approximately $0.5 million pre-tax ($0.3 million after-tax) to extinguish this debt.

The Corporation used the remaining surplus cash proceeds, together with the proceeds of the Trust Securities sold by First Charter Capital Trust II, or approximately $224 million, to repay FHLB overnight borrowings. The Corporation did not incur a prepayment penalty related to this payment.

These initiatives were executed during late October due to the relatively favorable interest rate environment and the increased risks that interest rates would rise. First Charter reduced the size of its investment portfolio as a percentage of total assets from 29 percent at the end of September 2005 to approximately 22 percent at December 31, 2005. First Charter has also reduced its reliance on wholesale

borrowings as a percentage of total liabilities from 41 percent at the end of September 2005 to approximately 33 percent at December 31, 2005.

Separately, the Corporation issued $35 million and $25 million in floating rate, trust-preferred securities (the Trust Securities) through specially formed subsidiary trusts in the second quarter (First Charter Capital Trust I) and third quarter (First Charter Capital Trust II) of 2005, respectively, to ensure that it has sufficient capital and liquidity to support anticipated future growth.

Market Expansion Raleigh, NC

During 2005, First Charter implemented a growth strategy intended to both expand the First Charter footprint into high growth markets and optimize existing locations through attracting new customers and retaining existing customers. As part of the strategic growth strategy, First Charter has expanded operations into the Raleigh, NC Metro area. The Raleigh Metro area is expected to have at or above average household income and growth rates relative to the North Carolina and national averages.

First Charter opened a loan production office in Raleigh in the first quarter of 2005 which was later consolidated into its first financial center in Raleigh on October 3, 2005. The financial center offers a full suite of banking services to individuals and small businesses, commercial lending, mortgages, and brokerage services. This office also serves as the regional headquarters. First Charter also operates 23 ATMs in the Raleigh market.

The Corporation expanded its presence in the Raleigh area by opening 3 additional full-service financial centers and 3 ATMs in the first quarter of 2006.

Existing Markets

First Charter opened new replacement financial centers in Monroe, Concord, and Charlotte NC during 2005, providing an even greater level of service and convenience for customers in those markets. First Charter also added a new financial center in Charlotte on October 24, 2005, bringing the total number of financial centers to 55 at December 31, 2005.

The Community Banking Model

In order to attract new customers and retain existing customers, First Charter adopted a community banking model focused on delivering our clients with a broad array of financial products and solutions, delivered with exceptional service and convenience at a fair price. It emphasizes local market decision making and management whenever possible. Management believes this model works well against both it s larger competitors that may have less flexibility, as well as local competition that may not have the array of products and services that First Charter can offer. First Charter competes against three of the largest banks in the country as well as other local banks, savings and loan associations, credit unions and finance companies. Management believes that by focusing on core values, striving to expand our clients expectations, being an employer of choice and providing exceptional value to shareholders, First Charter can achieve the profitability and growth goals it has set for itself.

Financial Summary

Net income amounted to $25.3 million, or $0.82 per diluted share, for the year ended December 31, 2005, a decrease from net income of $42.4 million, or $1.40 per diluted share, for the year ended December 31, 2004. As previously reported, in the fourth quarter of 2005, the Corporation incurred an approximate $20.0 million after-tax charge resulting from a series of balance sheet initiatives, which included the sale of securities and the extinguishment of debt and termination of interest rate swaps. The return on average assets and return on common shareholders equity was 0.56 percent and 7.86 percent in 2005, respectively, compared to 0.98 percent and 14.05 percent in 2004, respectively.

Earnings Analysis for Fourth Quarter 2005

Net income (loss) amounted to $(8.3) million, or $(0.27) per diluted share, for the three months ended December 31, 2005, compared to net income of $11.6 million, or $0.38 per diluted share for the same period in 2004. Net income for the three months ended December 31, 2005 was impacted by the previously discussed balance sheet repositioning.

Net interest income increased $0.1 million to $31.9 million, or $32.5 million on a taxable equivalent basis, compared to the fourth quarter of 2004. The net interest margin increased 12 basis points to 3.27 percent compared to the fourth quarter of 2004. The expansion of the margin was primarily the result of the balance sheet repositioning, an increase in loan yield and an increase in the percentage of earning assets funded by low cost core deposits (money market, demand and savings accounts).

Noninterest income totaled $39,000 compared to $15.3 million for the fourth quarter of 2004. Included in the totals were securities gains (losses) of $(16.7) million for the fourth quarter of 2005 resulting from the balance sheet repositioning compared to securities gains of $0.3 million for the fourth quarter of 2004. Excluding securities gains and losses, noninterest income increased $1.7 million, or 11 percent, to $16.7 million. Increases in deposit, ATM, debit card, mortgage, and financial management revenues were key contributors to the growth. In addition, property sale gains were $0.6 million in the fourth quarter of 2005 compared to no gains in the fourth quarter of 2004.

Noninterest expense for the fourth quarter of 2005 totaled $44.0 million and included a $7.8 million charge to terminate derivative transactions and a $6.9 million charge due to the early extinguishment of debt, both of which related to the balance sheet repositioning. Excluding these charges, noninterest expense was $29.4 million. This compares to fourth quarter 2004 noninterest expense of $27.7 million. The increase was primarily due to a $1.9 million increase in salaries and employee benefits related to additional personnel, increased commission-based compensation and higher medical costs. Partially offsetting this increase was a $1.1 million decrease in occupancy and equipment expense due to a $1.4 million fixed asset correction as part of a fixed asset inventory conducted during 2005.

An income tax benefit of $5.5 million was recognized in the fourth quarter of 2005 compared to an income tax expense of $6.1 million for the fourth quarter of 2004. The income tax benefit for the fourth quarter was due to a decrease in the estimated 2005 effective tax rate resulting from the charge related to the previously mentioned balance sheet repositioning.

Table One
Selected Financial Data

(Dollars in thousands, except per share amounts)	Years ended December 31, **2005**	2004	2003	2002	2001
Income statement					
Interest income	**$ 224,605**	$ 187,303	$ 178,292	$ 196,388	$ 215,276
Interest expense	**99,722**	64,293	70,490	83,227	109,912
Net interest income	**124,883**	123,010	107,802	113,161	105,364
Provision for loan losses	**9,343**	8,425	27,518	8,270	4,465
Noninterest income	**50,213**	60,896	63,933	47,410	38,773
Noninterest expense	**131,222**	111,017	126,785	97,551	87,579
Income before income taxes	**34,531**	64,464	17,432	54,750	52,093
Income tax expense	**9,220**	22,022	3,286	14,947	16,768
Net income	**$ 25,311**	$ 42,442	$ 14,146	$ 39,803	$ 35,325
Per common share					
Basic net income	**$ 0.83**	$ 1.42	$ 0.47	$ 1.30	$ 1.12
Diluted net income	**0.82**	1.40	0.47	1.30	1.12
Cash dividends declared	**0.76**	0.75	0.74	0.73	0.72
Period-end book value	**10.53**	10.47	10.08	10.80	10.06
Average shares outstanding basic	**30,457,573**	29,859,683	29,789,969	30,520,125	31,480,109
Average shares outstanding diluted	**30,784,406**	30,277,063	30,007,435	30,702,107	31,660,985
Ratios					
Return on average shareholders equity	**7.86%**	14.05%	4.50%	12.52%	11.03%
Return on average assets	**0.56**	0.98	0.35	1.13	1.14
Net interest margin (2)	**3.05**	3.14	3.00	3.52	3.72
Average loans to average deposits	**102.01**	92.86	86.60	94.30	95.43
Average equity to average assets	**7.18**	6.99	7.85	9.02	10.31
Efficiency ratio (1)(2)	**60.05**	60.44	65.79	64.29	60.97
Dividend payout	**92.68**	53.57	157.45	56.15	64.29
Selected period end balances					
Securities available for sale	**$ 899,111**	$ 1,652,732	$ 1,601,900	$ 1,129,212	$ 1,076,324
Loans held for sale	**6,447**	5,326	5,137	158,404	7,334
Loans, net	**2,917,020**	2,412,529	2,227,030	2,045,266	1,921,718
Allowance for loan losses	**28,725**	26,872	25,607	27,204	25,843
Total assets	**4,232,420**	4,431,605	4,206,693	3,745,949	3,332,737
Total deposits	**2,799,479**	2,609,846	2,427,897	2,322,647	2,162,945
Borrowings	**1,068,574**	763,738	473,106	1,042,440	808,512
Total liabilities	**3,908,825**	4,116,918	3,907,254	3,421,263	3,023,396
Total shareholders equity	**323,595**	314,687	299,439	324,686	309,341
Selected average balances					
Loans and loans held for sale	**2,795,711**	2,363,107	2,152,748	2,122,890	1,990,406
Earning assets	**4,164,969**	4,004,678	3,662,460	3,261,844	2,881,295

Total assets	**4,489,083**	4,322,727	4,009,511	3,525,090	3,104,952
Total deposits	**2,740,742**	2,544,865	2,485,711	2,251,256	2,085,669
Borrowings	**1,375,910**	1,428,124	1,159,889	906,263	652,298
Total shareholders equity	**322,226**	302,101	314,562	317,952	320,215

(1) *Noninterest expense less debt extinguishment expense and derivative termination costs divided by the sum of taxable equivalent net interest income plus noninterest income less (loss) gain on sale of securities.*

(2) *Amounts and ratios in 2004 have been adjusted to correct a calculation error with respect to the taxable-equivalent adjustment.*

Critical Accounting Estimates and Policies

The Corporation s significant accounting policies are described in ***Note One*** of the consolidated financial statements and are essential in understanding management s discussion and analysis of financial condition and results of operations. Some of the Corporation s accounting policies require significant judgment to estimate values of either assets or liabilities. In addition, certain accounting principles require significant judgment in applying the complex accounting principles to complicated transactions to determine the most appropriate treatment.

The following is a summary of the more judgmental estimates and complex accounting principles. In many cases, there are numerous alternative judgments that could be used in the process of estimating

values of assets or liabilities. Where alternatives exist, the Corporation has used the factors that we believe represent the most reasonable value in developing the inputs for the valuation. Actual performance that differs from the Corporation s estimates of the key variables could impact net income.

Allowance for Loan Losses

The Corporation considers its policy regarding the allowance for loan losses to be one of its most critical accounting policies, as it requires some of management s most subjective and complex judgments. The allowance for loan losses is maintained at a level the Corporation believes is adequate to absorb probable losses inherent in the loan portfolio as of the date of the consolidated financial statements. The Corporation has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses that reflect its careful evaluation of credit risk considering all information available to us.

The determination of the level of the allowance and, correspondingly, the provision for loan losses, rests upon various judgments and assumptions, including: (i) general economic conditions, (ii) loan portfolio composition, (iii) prior loan loss experience, (iv) management s evaluation of credit risk related to both individual borrowers and pools of loans and (v) observations derived from the Corporation s ongoing internal credit review and examination processes and those of its regulators. Depending on changes in circumstances, future assessments of credit risk may yield materially different results, which may require an increase or decrease in the allowance for loan losses.

The Corporation employs a variety of statistical modeling and estimation tools in developing the appropriate allowance. The following provides a description of each of the components involved in the allowance for loan losses, the techniques the Corporation used and the estimates and judgments inherent to each component.

The first component of the allowance for loan losses, the valuation allowance for impaired loans, is computed based on documented reviews performed by the Corporation s Credit Risk Management. The reviews are completed for impaired commercial relationships greater than $150,000. Credit Risk Management typically estimates these valuation allowances by considering the fair value of the underlying collateral for each impaired loan using current appraisals. The results of these estimates are updated quarterly or periodically as circumstances change. Changes in the dollar amount of impaired loans or in the estimates of the fair value of the underlying collateral can impact the valuation allowance on impaired loans and, therefore, the overall allowance for loan losses.

The second component of the allowance for loan losses, the portion attributable to all other loans without specific reserve amounts, is determined by applying loss rates to the outstanding balance of loans. The portfolio is segmented into two major categories: commercial loans and consumer loans. Commercial loans are segmented further by risk grade and type, so that separate loss factors are applied to each pool of commercial loans. The loss factors applied to the commercial segments are determined using a migration analysis tool that computes current loss estimates by credit grade using a 60 month trailing loss history database. Since the migration analysis is based on trailing data, the percentage loss estimates can change based on actual losses. Changes in commercial loan credit grades or in the mix of the portfolio can also impact this component of the allowance for loan losses from period to period. Consumer loans which include mortgage, general consumer, consumer real estate, home equity and consumer unsecured loans are segmented by loan type and by collateral grouping in order to apply separate loss factors to each pool of consumer loans. The loss factors applied to the consumer segments are a thirty-six month rolling average of losses. Since the loss factors are based on historical data, the percentage loss estimates can change based on actual losses.

The third component of the allowance for loan losses is intended to capture the various risk elements of the loan portfolio which may not be sufficiently captured in the historical loss rates. These factors currently include intrinsic risk, operational risk, concentration risk and model risk. Intrinsic risk relates to the impact of current economic conditions on the Corporation s borrower base, the effects of which may not be realized by the Corporation in the form of charge-offs for several periods. The Corporation monitors and documents various local, regional and national economic data, and makes subjective estimates of the

impact of changes in economic conditions on the allowance for loan losses. Operational risk includes factors such as the likelihood of loss on a loan due to procedural error. Historically, the Corporation has made additional loss estimates for certain types of loans that were either acquired from other institutions in mergers or were underwritten using policies that are no longer in effect at the Corporation. These identified loans are considered to have higher risk of loss than currently reflected in historical loss rates of the Corporation, so additional estimates of loss are made by management. Concentration risk includes the risk of loss due to extensions of credit to a particular industry, loan type or borrower that may be troubled. Model risk reflects the inherent uncertainty of estimates within the allowance for loan losses model. The Corporation monitors its portfolio for any excessive concentrations of loans during each period, and if any excessive concentrations are noted, additional estimates of loss would be made. Changes in the allowance for loan losses for these subjective factors can arise from changes in the balance and types of outstanding loans, as well as changes in the underlying conditions which drive a change in the percentage used. As more fully discussed below, the Corporation continually monitors the portfolio in an effort to identify any other factors which may have an impact on loss estimates within the portfolio.

All estimates of the loan portfolio risk, including the adequacy of the allowance for loan losses, are subject to general and local economic conditions, among other factors, which are unpredictable and beyond the Corporation s control. Since a significant portion of the loan portfolio is comprised of real estate loans and loans to area businesses, the Corporation is subject to continued risk that the real estate market and economic conditions in general could change and therefore result in additional losses and require increases in the provision for loan losses. If management had made different assumptions about probable loan losses, the Corporation s financial position and results of operations could have differed materially. For additional discussion concerning the Corporation s allowance for loan losses and related matters, see **Allowance for Loan Losses**.

Income Taxes

Calculating the Corporation s income tax expense requires significant judgment and the use of estimates. The Corporation periodically assesses its tax positions based on current tax developments, including enacted statutory, judicial and regulatory guidance. In analyzing the Corporation s overall tax position consideration is given to the amount and timing of recognizing income tax liabilities and benefits. In applying the tax and accounting guidance to the facts and circumstances income tax balances are adjusted appropriately through the income tax provision.

Derivative Instruments

As of December 31, 2005, the Corporation had no stand-alone derivative instruments outstanding. The Corporation, however, may enter into interest rate swaps or other derivative instruments to achieve the Corporation s targeted interest rate profile. Interest rate swap agreements provide an exchange of interest payments computed on notional amounts that will offset any undesirable change in fair value resulting from market rate changes on designated hedged items. A swap agreement is a contract between two parties to exchange cash flows based on specified underlying notional amounts, assets and/or indices. The interest rate swap agreements utilized by the Corporation in the past qualified for hedge accounting as fair value hedges.

The fair value of interest rate swaps is valued on a quarterly basis by a third party and an internal valuation model. The valuation is determined using a discounted cash flow model, the implied forward interest rate curve and a volatility index. The Corporation performs a quarterly assessment based on the third party valuations to assess whether the derivative used in its hedging transaction has been highly effective in offsetting changes in the fair value of the hedged item. The effectiveness assessment is conducted using the cumulative dollar offset method.

According to the provisions of Statement of Financial Accounting Standards No. 133 (SFAS No. 133), if the change in the fair value of the derivative hedging instrument and the hedged item is believed to be one hundred percent correlated at inception, the short cut method of accounting would apply, resulting in a presumption of no hedge ineffectiveness and no income statement impact. For interest rate swaps that do not meet the criteria for the short-cut accounting method, the Corporation records on a quarterly basis,

in noninterest income, the net change in the fair value of the interest rate swap and the designated hedged item, attributed to changes in interest rates, provided the criteria for hedge accounting continue to be met. In the event the criteria for hedge accounting are not met in a future period, the Corporation will cease recording the change in fair value of the hedged item and will amortize into earnings the then carrying value of the interest rate swap over the life of the hedged item. The derivative hedging instruments were recorded at fair value in other assets or other liabilities.

The Corporation formally documents at inception all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various hedge transactions as required by Statement of Financial Accounting Standards No. 133. This documentation includes analysis at inception and is ongoing relative to the effectiveness of the hedging relationship. If the Corporation s initial judgments were inappropriate, hedge accounting would be reversed and only the change in fair value of the derivative would be recognized through the income statement. The Corporation will discontinue hedge accounting when it is determined that a derivative is not expected to be or has ceased to be highly effective as a hedge, and will reflect changes in fair value through the income statement.

Earnings Performance

Net Interest Income and Margin

Net interest income, the difference between total interest income and total interest expense, is the Corporation s principal source of earnings. An analysis of the Corporation s net interest income on a taxable-equivalent basis and average balance sheets for the last three years is presented in ***Table Two***. Net interest income on a taxable-equivalent basis (FTE) is a non-GAAP (Generally Accepted Accounting Principles) performance measure used by management in operating the business which management believes provides investors with a more accurate picture of the interest margin for comparative purposes. The changes in net interest income (on a taxable-equivalent basis) from year to year are analyzed in ***Table Three***. The discussion below is based on net interest income computed under accounting principles generally accepted in the United States of America.

For the year ended December 31, 2005, net interest income amounted to $124.9 million, an increase of approximately 2 percent from net interest income of $123.0 million in 2004. This increase was primarily due to a $432.6 million increase in average loan balances, an increase in the proportion of noninterest bearing deposits to the composition of funding sources and to a lesser extent the balance sheet repositioning which occurred in late October 2005. This was partially offset by higher rates paid on interest bearing liabilities relative to increases in asset yields.

The net interest margin (tax-adjusted net interest income divided by average interest-earning assets) decreased 9 basis points to 3.05 percent in 2005, compared to 3.14 percent in 2004. The net interest margin was negatively impacted by a 91 basis point increase in the cost of interest bearing liabilities. Partially offsetting this increase was a 72 basis point increase in earning asset yields compared to 2004. Since the balance sheet repositioning occurred in late October 2005, the benefit to the net interest margin for the year was minimal.

The cost of interest bearing liabilities was impacted by a 137 basis point increase in other borrowing costs and a 66 basis point increase in deposit yields compared to 2004. Interest-bearing liability average balances increased $107.5 million compared to 2004. The increase was primarily due to a $159.8 million increase in interest-bearing deposit average balances compared to 2004, as retail certificates of deposit average balances increased $67.8 million and wholesale deposit average balances increased $102.9 million. Partially offsetting this increase was a $52.2 million decline in other borrowing average balances, primarily wholesale borrowings.

Earning asset yields were impacted by a 92 basis point increase in loan yields and a 6 basis point decrease in security yields compared to 2004. Interest earning asset average balances increased $160.3 million to $4.16 billion at December 31, 2005 compared to $4.0 billion for the same 2004 period. These

increases were primarily due to growth in the Corporation s average loan balances, which increased $432.6 million, compared to December 31, 2004. Loan balances increased, in part, due to the purchase of whole loan adjustable-rate mortgage (ARM) loans during the first quarter of 2005, which contributed $178.9 million to average loans and loans held for sale. This purchase was executed under a previously disclosed strategy in which the sale of investment securities and portfolio cash flows would fund the ARM loan purchases. These ARM loans have similar average lives and a higher yield than the securities sold. The ARM loan purchase and the balance sheet repositioning contributed to a $261.6 million reduction in the average balance of the securities portfolio, compared to December 31, 2004.

The Corporation s primary interest rate risk management objective is to maximize net interest income across a broad range of interest rate scenarios, subject to risk tolerance limits set by Management and the Board of Directors. As previously discussed, the Corporation repositioned its balance sheet in the fourth quarter of 2005. The Corporation expects the repositioning of the balance sheet to improve net interest income and the net interest margin and reduce interest rate risk.

The following table includes interest income on interest earning assets and related average yields, as well as interest expense on interest-bearing liabilities and related average rates paid. In addition, the table includes the net interest margin. Average balances were calculated based on daily balances.

Table Two

Average Balances and Net Interest Income Analysis

	2005			2004			2003		
(Dollars in thousands)	**Average Balance**	**Interest Income/ Expense**	**Average Yield/Rate Paid**	Average Balance	Interest Income/ Expense	Average Yield/Rate Paid	Average Balance	Interest Income/ Expense	Average Yield/Rate Paid
Interest earning assets:									
Loans and loans held for sale[1][2][3]	**$2,795,711**	**$172,961**	**6.19%**	$2,363,107	$124,496	5.27%	$2,152,748	$119,375	5.55%
Securities taxable[5]	**1,251,477**	**47,657**	**3.81**	1,538,133	59,520	3.87	1,393,277	55,596	3.99
Securities nontaxable [5]	**110,030**	**6,100**	**5.54**	84,969	5,224	6.15	71,427	5,077	7.11
Federal funds sold	**1,883**	**60**	**3.19**	1,566	19	1.22	2,074	20	0.99
Interest bearing bank deposits	**5,868**	**163**	**2.78**	16,903	200	1.18	42,934	465	1.08
Total earning assets[4][5]	**4,164,969**	**226,941**	**5.45**	4,004,678	189,459	4.73	3,662,460	180,533	4.93
Cash and due from banks	**94,971**			89,103			90,941		
Other assets	**229,143**			228,946			256,110		
Total assets	**$4,489,083**			$4,322,727			$4,009,511		
Interest bearing liabilities:									
Demand deposits	**840,645**	**10,331**	**1.23**	848,597	6,643	0.78	778,600	6,997	0.90
Savings deposits	**123,305**	**277**	**0.22**	122,339	321	0.26	118,459	520	0.44
Other time deposits	**1,378,634**	**42,848**	**3.11**	1,211,890	28,386	2.34	1,253,538	34,027	2.71

Other borrowings	**1,375,910**	**46,266**	**3.36**	1,428,124	28,943	1.99	1,159,889	28,946	2.50
Total interest bearing liabilities	**3,718,494**	**99,722**	**2.68**	3,610,950	64,293	1.77	3,310,486	70,490	2.13
Noninterest bearing sources:									
Noninterest bearing deposits	**398,158**			362,038			335,114		
Other liabilities	**50,205**			47,638			49,349		
Shareholders equity	**322,226**			302,101			314,562		
Total liabilities and shareholders equity	**$4,489,083**			$4,322,727			$4,009,511		
Net interest spread [5]			**2.77**			2.96			2.80
Impact of noninterest bearing sources			**0.28**			0.18			0.20
Net interest income/ yield on earning assets[5]		**$127,219**	**3.05%**		$125,166	3.14%		$110,043	3.00%

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

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

(3) *Includes amortization of deferred loan fees of approximately $2,343, $2,616, and $2,576, for 2005, 2004 and 2003, respectively.*

(4) *Yields on nontaxable securities and*

loans are stated on a taxable-equivalent basis, assuming a Federal tax rate of 35 percent and applicable state taxes for 2005, 2004 and 2003. The adjustments made to convert to a taxable-equivalent basis were $2,336, $2,156, and $2,241 for 2005, 2004 and 2003, respectively.

(5) *Amounts in 2004 have been adjusted to correct a calculation error with respect to the taxable-equivalent adjustment.*

Changes in net interest income for the last two years are as follows:

Table Three

Volume and Rate Variance Analysis

		Dec. 31, 2005 versus Dec. 31, 2004 versus Dec. 31, 2003					
		Increase (Decrease) in Net Interest Income Due to Change in Rate and Volume [1]					
(Dollars in thousands)	**2005 Income/ Expense**	**Rate**	**Volume**	**2004 Income/ Expense**	Rate	Volume	2003 Income/ Expense
Interest income:							
Loans and loans held for sale [2]	**$172,961**	**$23,688**	**$ 24,777**	**$124,496**	$(6,253)	$11,374	$119,375
Securities taxable (3)	**47,657**	**(857)**	**(11,006)**	**59,520**	(1,771)	5,695	55,596
Securities nontaxable [2][3]							