

FLAG FINANCIAL CORP  
Form 10-Q  
November 08, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 30, 2006

OR

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-24532

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**FLAG FINANCIAL CORPORATION**

*(Exact name of registrant as specified in its charter)*

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**Georgia**  
*(State of incorporation)*

**3475 Piedmont Road N.E. Suite 550**

**Atlanta, Georgia 30305**

*(Address of principal executive offices)*

**58-2094179**  
*(I.R.S. Employer Identification No.)*

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(404) 760-7700

*(Registrant's telephone number)*

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definitions of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Common stock, par value \$1 per share: 17,009,478 shares outstanding as of November 2, 2006

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**Flag Financial Corporation and Subsidiary**

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**Table of Contents****Part I. Financial Information****Item 1. Financial Statements****FLAG FINANCIAL CORPORATION AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS***(in thousands, except share data)*

|   | September 30,<br>2006<br><i>(unaudited)</i> | December 31,<br>2005<br><i>(audited)</i> | September 30,<br>2005<br><i>(unaudited)</i> |
|---|---|--|---|
| <b>Assets</b>   |   |  |   |
| Cash and due from banks   | \$ 41,636                                   | \$ 45,506                                | \$ 16,101                                   |
| Other interest-bearing deposits in banks  | 159   | 23,184                                   | 5,946                                       |
| Federal funds sold  |   | 2,085                                    | 24,578                                      |
| <b>Total cash and cash equivalents</b>  | <b>41,795</b>                               | 70,775                                   | 46,625                                      |
| Other interest-bearing deposits   | 349   | 4,698                                    | 4,000                                       |
| Investment securities available-for-sale  | 294,605                                     | 228,442                                  | 99,878                                      |
| Other investments   | 17,245                                      | 18,762                                   | 12,332                                      |
| Mortgage loans held-for-sale  | 7,710                                       | 11,665                                   | 10,401                                      |
| Loans, net of allowance for loan losses of \$17,237, \$16,779 and \$9,511, respectively   | 1,249,140                                   | 1,205,046                                | 691,488                                     |
| Premises and equipment, net   | 14,668                                      | 13,985                                   | 13,458                                      |
| Intangible assets   | 114,814                                     | 115,034                                  | 20,986                                      |
| Other assets  | 35,816                                      | 34,454                                   | 19,957                                      |
| <b>Total assets</b>   | <b>\$ 1,776,142</b>                         | \$ 1,702,861                             | \$ 919,125                                  |
| <b>Liabilities and Stockholders' Equity</b>   |   |  |   |
| <b>Deposits:</b>  |   |  |   |
| Noninterest-bearing deposits  | \$ 197,047                                  | \$ 172,725                               | \$ 57,372                                   |
| Interest-bearing demand deposits  | 104,940                                     | 127,976                                  | 77,685                                      |
| Money market  | 443,849                                     | 404,488                                  | 270,286                                     |
| Savings   | 17,762                                      | 19,450                                   | 20,697                                      |
| Time  | 586,986                                     | 559,313                                  | 358,766                                     |
| <b>Total deposits</b>   | <b>1,350,584</b>                            | 1,283,952                                | 784,806                                     |
| Advances from Federal Home Loan Bank  | 130,291                                     | 143,469                                  | 25,000                                      |
| Federal funds purchased and repurchase agreements   | 9,819                                       | 4,142                                    | 1,420                                       |
| Junior subordinated debentures  | 46,785                                      | 46,791                                   | 24,743                                      |
| Other liabilities   | 19,996                                      | 19,707                                   | 8,504                                       |
| <b>Total liabilities</b>  | <b>1,557,475</b>                            | 1,498,061                                | 844,473                                     |
| <b>Preferred stock, 10,000,000 shares authorized, none issued and outstanding</b>   |   |  |   |
| <b>Common stock, \$1 par value, 40,000,000 shares authorized, 18,598,909, 18,425,034 and 10,097,272 shares issued at September 30, 2006, December 31, 2005 and September 30, 2005, respectively</b> |   |  |   |
|   | <b>18,599</b>                               | 18,425                                   | 10,097                                      |
| <b>Additional paid-in capital</b>   | <b>150,145</b>                              | 148,062                                  | 28,296                                      |

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|   |                     |              |            |
|---|---------------------|--------------|------------|
| Retained earnings   | <b>64,579</b>       | 51,692       | 49,875     |
| Accumulated other comprehensive (loss) income   | <b>(134)</b>        | 125          | (112)      |
| Less: Treasury stock at cost; 1,589,431 shares at September 30, 2006, and 1,551,186 at December 31, 2005 and September 30, 2005 | <b>(14,522)</b>     | (13,504)     | (13,504)   |
| Total stockholders' equity  | <b>218,667</b>      | 204,800      | 74,652     |
| Total liabilities and stockholders' equity  | <b>\$ 1,776,142</b> | \$ 1,702,861 | \$ 919,125 |

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****FLAG FINANCIAL CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF EARNINGS***(in thousands, except per share data)*

|  | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2006                                | 2005          | 2006                               | 2005          |
|  | <i>(unaudited)</i>                  |               |                                    |               |
| <b>Interest income:</b>  |                                     |               |                                    |               |
| Interest and fees on loans   | \$ 27,232                           | \$ 14,279     | \$ 77,631                          | \$ 38,120     |
| Interest on investment securities                                  | 4,209                               | 1,339         | 11,968                             | 3,719         |
| Interest on federal funds sold and other interest-bearing deposits | 118                                 | 315           | 993                                | 945           |
| <b>Total interest income</b>                                       | <b>31,559</b>                       | <b>15,933</b> | <b>90,592</b>                      | <b>42,784</b> |
| <b>Interest expense:</b>   |                                     |               |                                    |               |
| Interest on deposits:  |                                     |               |                                    |               |
| Demand   | 271                                 | 209           | 834                                | 682           |
| Money market   | 4,797                               | 2,130         | 13,034                             | 5,281         |
| Savings  | 33                                  | 35            | 100                                | 98            |
| Time   | 7,068                               | 2,857         | 18,557                             | 7,369         |
| Interest on other borrowings                                       | 2,769                               | 586           | 7,581                              | 1,412         |
| <b>Total interest expense</b>                                      | <b>14,938</b>                       | <b>5,817</b>  | <b>40,106</b>                      | <b>14,842</b> |
| Net interest income before provision for loan losses               | 16,621                              | 10,116        | 50,486                             | 27,942        |
| <b>Provision for loan losses</b>                                   |                                     | 375           | 550                                | 750           |
| Net interest income after provision for loan losses                | 16,621                              | 9,741         | 49,936                             | 27,192        |
| <b>Noninterest income:</b>   |                                     |               |                                    |               |
| Service charges on deposit accounts                                | 798                                 | 855           | 2,315                              | 2,428         |
| Mortgage banking activities  | 770                                 | 890           | 2,468                              | 2,157         |
| Payroll services fees  | 673                                 | 542           | 2,089                              | 1,622         |
| Insurance commissions and brokerage fees                           | 72                                  | 66            | 275                                | 198           |
| (Loss) gain on sales of other real estate owned                    | (4)                                 | 336           | 135                                | 558           |
| Gain on sales of investment securities available-for-sale          |                                     |               |                                    | 129           |
| Other  | 482                                 | 345           | 1,876                              | 1,136         |
| <b>Total noninterest income</b>                                    | <b>2,791</b>                        | <b>3,034</b>  | <b>9,158</b>                       | <b>8,228</b>  |
| <b>Noninterest expense:</b>  |                                     |               |                                    |               |
| Salaries and employee benefits                                     | 7,324                               | 5,539         | 20,767                             | 15,759        |
| Occupancy  | 1,156                               | 977           | 3,559                              | 2,915         |
| Professional fees  | 110                                 | 429           | 844                                | 1,462         |
| Postage, printing and supplies                                     | 505                                 | 257           | 1,380                              | 734           |
| Communications   | 678                                 | 539           | 2,175                              | 1,648         |
| Merger-related charges   | 359                                 |               | 359                                |               |
| Other  | 1,740                               | 1,114         | 5,039                              | 2,876         |
| <b>Total noninterest expense</b>                                   | <b>11,872</b>                       | <b>8,855</b>  | <b>34,123</b>                      | <b>25,394</b> |

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|  |                 |          |                  |          |
|--|-----------------|----------|------------------|----------|
| Earnings before provision for income taxes | <b>7,540</b>    | 3,920    | <b>24,971</b>    | 10,026   |
| Provision for income taxes                 | <b>2,762</b>    | 1,283    | <b>9,001</b>     | 3,256    |
| <b>Net earnings</b>                        | <b>\$ 4,778</b> | \$ 2,637 | <b>\$ 15,970</b> | \$ 6,770 |
| Basic earnings per share                   | <b>\$ 0.28</b>  | \$ 0.31  | <b>\$ 0.94</b>   | \$ 0.79  |
| <b>Diluted earnings per share</b>          | <b>\$ 0.27</b>  | \$ 0.28  | <b>\$ 0.90</b>   | \$ 0.73  |

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****FLAG FINANCIAL CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(in thousands)*

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2006</b>               | <b>2005</b> | <b>2006</b>              | <b>2005</b> |
|   | <i>(unaudited)</i>        |             |                          |             |
| Net earnings  | <b>\$ 4,778</b>           | \$ 2,637    | <b>\$ 15,970</b>         | \$ 6,770    |
| Other comprehensive income, net of tax:   |                           |             |                          |             |
| Unrealized gains (losses) on investment securities available-for-sale:  |                           |             |                          |             |
| Unrealized gains (losses) arising during the period, net of income tax (benefit) of \$1,332, \$165, \$(256) and \$7, respectively | <b>2,174</b>              | 270         | <b>(418)</b>             | 11          |
| Reclassification adjustment for gains included in net earnings, net of income tax of \$0, \$0, \$0 and \$49, respectively         |                           |             |                          | (80)        |
| Unrealized gains (losses) on cash flow hedges, net of income tax (benefit) of \$56, \$(80), \$97 and \$(61), respectively         | <b>91</b>                 | (131)       | <b>159</b>               | (99)        |
| <b>Other comprehensive income (loss)</b>  | <b>2,265</b>              | 139         | <b>(259)</b>             | (168)       |
| <b>Comprehensive income</b>   | <b>\$ 7,043</b>           | \$ 2,776    | <b>\$ 15,711</b>         | \$ 6,602    |

See accompanying notes to unaudited consolidated financial statements.



**Table of Contents****FLAG FINANCIAL CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS***(in thousands)*

|   | Nine Months Ended<br>September 30, |               |
|---|------------------------------------|---------------|
|   | 2006                               | 2005          |
| <b>Cash flows from operating activities:</b>  |                                    |               |
| Net earnings  | \$ 15,970                          | \$ 6,770      |
| Adjustment to reconcile net earnings to net cash provided by operating activities:    |                                    |               |
| Depreciation, amortization and accretion  | 1,493                              | 1,484         |
| Provision for loan losses   | 550                                | 750           |
| Stock-based compensation  | 413                                |               |
| Gain on sales of investment securities available-for-sale                             |                                    | (129)         |
| Gain on sales of loans  | (1,538)                            | (1,249)       |
| Gain on disposals of premises and equipment   | (223)                              | (23)          |
| Gain on sales of other real estate owned  | (135)                              | (558)         |
| Change in:  |                                    |               |
| Mortgage loans held-for-sale  | 5,493                              | 1,536         |
| Other assets and liabilities  | (2,681)                            | (2,348)       |
| Net cash provided by operating activities   | 19,342                             | 6,233         |
| <b>Cash flows from investing activities:</b>  |                                    |               |
| Net change in other interest-bearing deposits in banks                                | 4,349                              | 1,473         |
| Proceeds from sales, calls and maturities of investment securities available-for-sale | 27,864                             | 81,449        |
| Purchases of investment securities available-for-sale                                 | (93,164)                           | (70,118)      |
| Purchases of other investments  | (1,988)                            | (242)         |
| Proceeds from sales of other investments  | 2,758                              | 1,071         |
| Net change in loans   | (44,626)                           | (98,629)      |
| Proceeds from sale of other real estate owned   | 1,176                              | 3,277         |
| Proceeds from sale of premises and equipment  | 530                                | 871           |
| Purchases of premises and equipment   | (2,356)                            | (1,013)       |
| Net cash used in investing activities   | (105,457)                          | (81,861)      |
| <b>Cash flows from financing activities:</b>  |                                    |               |
| Net change in deposits  | 66,632                             | 77,959        |
| Change in federal funds purchased and repurchase agreements                           | 5,677                              | (875)         |
| Change in other borrowings  |                                    | (4,300)       |
| Proceeds from FHLB advances   | 60,000                             |               |
| Payments of FHLB advances   | (73,000)                           |               |
| Principal reduction of ESOP note payable  | 240                                |               |
| Proceeds from issuance of junior subordinated debt                                    |                                    | 10,310        |
| Proceeds from exercise of stock options   | 648                                | 385           |
| Cash dividends paid   | (3,062)                            | (1,542)       |
| Net cash provided by financing activities   | 57,135                             | 81,937        |
| Net change in cash and cash equivalents   | (28,980)                           | 6,309         |
| <b>Cash and cash equivalents at beginning of period</b>                               | <b>70,775</b>                      | <b>40,316</b> |

|   |                  |                  |
|---|------------------|------------------|
| <b>Cash and cash equivalents at end of period</b> | <b>\$ 41,795</b> | <b>\$ 46,625</b> |
|---|------------------|------------------|

See accompanying notes to unaudited consolidated financial statements.

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**Flag Financial Corporation and Subsidiary**

**Notes to Consolidated Financial Statements**

The accompanying consolidated financial statements have not been audited. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods.

**Note 1. Basis of Presentation**

The consolidated financial statements include the accounts of Flag Financial Corporation ( Flag or the Company ) and its wholly owned subsidiary, Flag Bank (the Bank ). All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial information furnished herein represents all adjustments that are, in the opinion of management, necessary to present a fair statement of the results of operations, changes in cash flows and financial position for the periods covered herein and are normal and recurring in nature. For further information, refer to the consolidated financial statements and related notes included in Flag s annual report on Form 10-K for the year ended December 31, 2005.

**Note 2. Mergers and Acquisitions**

On August 9, 2006, Flag Financial Corporation and RBC Centura Banks, Inc. ( RBC ) entered into an Agreement and Plan of Merger (the Merger Agreement ) pursuant to which RBC will acquire Flag (the Merger ). Under the terms of the Merger Agreement, upon the closing of the transaction, each outstanding share of Flag common stock will be converted into cash in the amount of \$25.50 per share.

The Merger has been approved by the boards of directors of both Flag and RBC and is subject to the approval of the shareholders of Flag. In addition to shareholder approval, the Merger is subject to customary regulatory approvals in the United States and in Canada including approval by the Board of Governors of the Federal Reserve System. The Merger Agreement also includes customary representations, warranties, covenants and other closing conditions of both parties. Flag and RBC expect the Merger to close prior to the end of 2006. For the third quarter and nine months ended September 30, 2006, merger-related charges totaling \$359,000 were incurred in connection with the impending merger with RBC and were primarily for investment banking, legal and other professional charges.

On November 21, 2005, Flag acquired 100 percent of the outstanding common shares of First Capital Bancorp ( First Capital ), a bank holding company headquartered in Norcross, Georgia. First Capital was the parent company of First Capital Bank, a community bank with five banking offices in the north metro Atlanta market. The merger accelerated Flag s strategy to continue to grow its presence in the metro Atlanta area. The consideration for the acquisition was a combination of cash and common stock with an aggregate purchase price of approximately \$137.6 million. The total consideration consisted of \$19.1 million in cash, approximately 6.9 million shares of Flag Financial common stock with a value of approximately \$112.7 million and 784,000 stock options with a value of approximately \$5.8 million. The value of the shares of common stock issued of \$16.28 was based on the average closing price of Flag s common stock for the 20 trading days immediately preceding the merger.

In conjunction with the merger, Flag accrued certain merger related expenses related to severance and personnel related charges, professional fees, contract termination costs, systems conversion and related charges. The severance and personnel related costs include severance, employee retention, payments related to change in control provisions of employment contracts and other costs associated with employee termination. Professional fees include investment bankers, legal and accounting fees. Contract termination costs include amounts owed to service providers as a result of early termination of service contracts. Systems conversion and related charges include charges necessary to convert the operations of acquired branches. At September 30, 2006, accrued merger costs of \$429,000 remained unpaid.

**Table of Contents****Flag Financial Corporation and Subsidiary****Notes to Consolidated Financial Statements**

The following table presents a summary of merger accrual activity for 2006 (in thousands):

|   | Accrued at<br>December 31, 2005 | Utilized   | Reversed <sup>(1)</sup> | Balance at<br>September 30, 2006 |
|---|---------------------------------|------------|-------------------------|----------------------------------|
| Severance and personnel related charges | \$ 1,507                        | \$ (1,028) | \$ (50)                 | \$ 429                           |
| Professional fees                       | 3                               | (3)        |                         |                                  |
| Systems conversion and related charges  | 28                              | (28)       |                         |                                  |
| Total                                   | \$ 1,538                        | \$ (1,059) | \$ (50)                 | \$ 429                           |

<sup>(1)</sup> Reversal of merger accrual is a result of lower actual severance and personnel related charges than originally estimated.

**Note 3. Net Earnings Per Common Share**

Net earnings per common share are based on the weighted average number of common shares outstanding during each period. The calculation of basic and diluted earnings per share is as follows (in thousands, except per share amounts):

|   | Three Months Ended<br>September 30, |          | Nine Months<br>Ended<br>September 30, |          |
|---|-------------------------------------|----------|---------------------------------------|----------|
|   | 2006                                | 2005     | 2006                                  | 2005     |
| Basic earnings per share:   |                                     |          |                                       |          |
| Net earnings  | \$ 4,778                            | \$ 2,637 | \$ 15,970                             | \$ 6,770 |
| Weighted average common shares outstanding                        | 17,003                              | 8,546    | 16,939                                | 8,533    |
| Basic earnings per share  | \$ 0.28                             | \$ 0.31  | \$ 0.94                               | \$ 0.79  |
| Diluted earnings per share:                                       |                                     |          |                                       |          |
| Net earnings  | \$ 4,778                            | \$ 2,637 | \$ 15,970                             | \$ 6,770 |
| Weighted average common shares outstanding                        | 17,003                              | 8,546    | 16,939                                | 8,533    |
| Effect of stock options and warrants                              | 845                                 | 729      | 758                                   | 710      |
| Total weighted average common shares and common stock equivalents | 17,848                              | 9,275    | 17,697                                | 9,243    |
| Diluted earnings per share  | \$ 0.27                             | \$ 0.28  | \$ 0.90                               | \$ 0.73  |

**Note 4. Stock-based Compensation**

Effective January 1, 2006, Flag adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-Based Payment*. SFAS No. 123(R) requires compensation expense to be recognized for share-based payments over the vesting period based on the award's fair value at the date of grant. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as previously required.

**Table of Contents****Flag Financial Corporation and Subsidiary****Notes to Consolidated Financial Statements****Note 4. Stock-based Compensation, continued**

Flag adopted SFAS 123(R) using the modified prospective application; accordingly, the financial statements for periods prior to January 1, 2006, will not include compensation cost calculated under the fair value method. Under the modified prospective application, SFAS 123(R) applies to new awards and to awards modified, repurchased or cancelled after the effective date. SFAS 123(R) also applies to awards granted prior to, but not yet vested, as of January 1, 2006, as if the fair value method required for pro forma disclosure under SFAS 123, *Accounting For Stock-Based Compensation*, were in effect for expense recognition purposes. The substance of the revised statement is to require companies to record as an expense amortization of the fair market value of stock options determined as of the grant date. The offsetting credit is to additional paid-in capital unless there is an obligation to buy back the stock or exchange other assets for the stock. If such an obligation exists the offsetting credit would be to a liability account. For the quarter ended September 30, 2006, Flag recognized \$148,000 in share-based compensation costs or \$0.01 per basic and diluted share. For the nine months ended September 30, 2006, Flag recognized \$413,000 in share-based compensation costs or \$0.02 per basic and diluted share. As of September 30, 2006, all of Flag's unvested stock options are tax qualifying and no income tax benefits were recognized relating to the compensation expense.

Prior to the adoption of SFAS No. 123(R), Flag accounted for stock-based compensation to employees and non-employee members of the Board under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost was reflected in net earnings, as all stock options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net earnings and earnings per share if Flag had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the quarter and nine months ended September 30, 2005 (in thousands, except per share amounts):

|   | Three months ended<br>2005 | Nine months ended<br>2005 |
|---|----------------------------|---------------------------|
| Net earnings as reported  | \$ 2,637                   | \$ 6,770                  |
| Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of tax | (45)                       | (135)                     |
| Pro forma net earnings  | \$ 2,592                   | \$ 6,635                  |
| Basic earnings per share:   |                            |                           |
| As reported   | \$ 0.31                    | \$ 0.79                   |
| Pro forma   | \$ 0.30                    | \$ 0.78                   |
| Diluted earnings per share:   |                            |                           |
| As reported   | \$ 0.28                    | \$ 0.73                   |
| Pro forma   | \$ 0.28                    | \$ 0.72                   |

Flag sponsors an employee stock incentive plan and a director stock incentive plan. The plans were adopted for the benefit of directors and key officers and employees in order that they may purchase Flag stock at a price equal to the fair market value on the date of grant. A total of 1,314,000 shares were reserved for possible issuance under the employee plan and approximately 267,000 shares were reserved under the director plan. The options generally vest over a four-year period and expire after ten years. The plans expired in 2004 and a new plan was adopted. A total of 543,000 shares were reserved for the benefit of directors and key officers and employees under the new plan.

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**Flag Financial Corporation and Subsidiary**

**Notes to Consolidated Financial Statements**

**Note 4. Stock-based Compensation, continued**

In connection with the Company's 2002 private placement of common stock and warrants, warrants were issued for the purchases of common stock for \$1 per warrant. The warrants allow each holder to purchase one additional share of common stock for each share purchased in connection with the private placement and were issued as of the date of issuance of common stock sold in the private placement. There are 24,000 warrants issued, but not exercised at September 30, 2006. The warrants are exercisable for a period of ten years following the 2002 issuance at prices of \$9.10 per share.

First Capital had stock option plans for key employees with similar provision as Flag's plan. Options under First Capital's acquired plans were converted at the exchange ratio effective for common shares of 1.6 per share. No options are available for grant under the acquired plans.

A summary of activity in the warrants and stock option plans is presented below.

|  | Shares        | Weighted<br>Average<br>Price<br>Per Share |
|--|---------------|---|
| Outstanding, at December 31, 2005      | 1,746,656     | \$ 10.59                                  |
| Granted during the year                | 41,500        | 18.05                                     |
| Cancelled during the year              | (28,313)      | 13.16                                     |
| Exercised during the year              | (180,200)     | 6.84                                      |
| <br>Outstanding, at September 30, 2006 | <br>1,579,643 | <br>\$ 11.17                              |

A summary of options and warrants outstanding as of September 30, 2006 is presented below:

| Options<br>and Warrants<br>Outstanding | Range of<br>Price per<br>Share | Weighted<br>Average<br>Price<br>Per Share | Years<br>Remaining | Options<br>and Warrants<br>Currently<br>Exercisable | Weighted<br>Average<br>Price<br>Per Share |
|--|--------------------------------|---|--------------------|---|---|
| 294,431                                | \$ 4.45 - 6.75                 | \$ 5.98                                   | 3                  | 294,431   | \$ 5.98                                   |
| 443,956                                | 6.76 - 10.00                   | 8.21                                      | 4                  | 443,956   | 8.21                                      |
| 841,256                                | 10.01 - 19.31                  | 14.54                                     | 7                  | 593,396   | 14.29                                     |
| <br>1,579,643                          | <br>\$ 4.45 - 19.31            | <br>\$ 11.17                              | <br>6              | <br>1,331,783                                       | <br>\$ 10.42                              |

During the first nine months of 2006 and 2005 the fair value of each option was estimated on the date of grant using the Black-Scholes options-pricing model. The risk-free interest rate is based upon a U.S. Treasury instrument with a life that is similar to the expected life of the option grant. Expected volatility is based upon the historical volatility of the Company's common stock based upon prior years trading history. The expected term of the options is based upon the average life of previously issued stock options. The expected dividend yield is based upon current yield on date of grant.

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The following table illustrates the assumptions for the Black-Scholes model used in determining the fair value of options granted to employees in the quarters presented.

|   | Nine Months Ended September 30, |               |
|---|---------------------------------|---------------|
|   | 2006                            | 2005          |
| Options issued                          | 41,500                          | 81,500        |
| Weighted average grant date fair value  | \$5.40                          | \$3.93        |
| Risk-free interest rate (range)         | 4.37%-5.07%                     | 4.24%-4.36%   |
| Expected dividend yield (range)         | 1.45%-1.56%                     | 1.72%-1.80%   |
| Expected stock price volatility (range) | 0.2260-0.2445                   | 0.2185-0.2225 |
| Expected life                           | 7 years                         | 7 years       |

Responsive to its plan of implementation of SFAS No. 123(R) and consistent with Flag's long-term compensation strategies, the Board of Directors of Flag approved the granting of 232,000 options in the fourth quarter of 2005 which were vested immediately. The decision to accelerate the vesting of these options was made primarily to reduce noncash compensation expense that would have been recorded in Flag's statement of earnings in future periods as a result of the adoption of SFAS No. 123(R) in January 2006.

As of September 30, 2006, there was \$667,000 in total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. The cost is expected to be recognized over a weighted average period of 9.0 months. At the closing of the merger with RCB, all nonvested share-based compensation arrangements granted under the plans will automatically vest and Flag will recognize the remaining unrecognized compensation costs.

**Note 5. Recent Accounting Pronouncements**

In addition to the adoption of SFAS No. 123(R) in the first quarter of 2006, the following are other recent accounting pronouncements affecting Flag.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB No. 108), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 was effective as of the issuance date, allowing a one-time transitional cumulative effect adjustment to beginning retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB No. 108. Flag is in the process of assessing the impact of SAB No. 108 on its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements required under other accounting pronouncements that require or permit fair value measurements. This statement is effective for fiscal years beginning after November 15, 2007. Flag is in the process of assessing the impact of SFAS No. 157 on its financial position and results of operations.

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**Notes to Consolidated Financial Statements**

**Note 5. Recent Accounting Pronouncements, continued**

In July 2006, the FASB issued FASB Interpretation Number ( FIN ) 48, *Accounting for Uncertainty in Income Taxes*. This interpretation provides a two-step approach for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return and may result in companies revising their threshold for recognition of tax benefits that have some degree of uncertainty. FIN 48, which interprets SFAS No. 109, *Accounting for Income Taxes*, also addresses the accrual of any interest and penalties related to tax uncertainties and requires additional tax related disclosures. FIN 48 is effective beginning January 1, 2007 for calendar year companies. Flag is in the process of assessing the impact of this interpretation on its financial position and results of operations.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of SFAS No. 133 and 140*. This statement provides entities with relief from having to separately determine the fair value of an embedded derivative that would otherwise be required to be bifurcated from its host contract in accordance with the requirements of SFAS No. 133. Entities can make an irrevocable election to measure such hybrid financial instruments at fair value in its entirety, with subsequent changes in fair value recognized in earnings. This election can be made on an instrument-by-instrument basis. The effective date of this standard is for all financial instruments acquired, issued or subject to a remeasurement event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. SFAS No. 155 is not expected to have a material impact on Flag's financial position, results of operations or disclosures.

In November 2005, the FASB issued FSP Nos. FAS 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment. The FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in the FSP amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The new disclosure requirements of FSP Nos. FAS 115-1 and 124-1 are effective for reporting periods beginning after December 15, 2005. During the quarter and nine month period ended September 30, 2006, the Company did not experience any other-than-temporary impairment.



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

**Forward-Looking Statements**

The following discussion and comments contain "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of our management, as well as assumptions made by and information currently available to our management. The words "expect", "estimate", "anticipate", and "believe", as well as similar expressions, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, (i) the strength of the U.S. economy as well as the strength of the local economies in which operations are conducted; (ii) the effects of changing interest rates, which could lower margins; (iii) unanticipated inflation, interest rate, market and monetary fluctuations; (iv) unanticipated regulatory proceedings or legal actions, or changes in accounting policies and practices as adopted by the Financial Accounting Standards Board; (v) issues involved in the integration of acquisitions; and (vi) the timely development of products and services that position Flag to succeed in an increasingly competitive industry. If we are unsuccessful in managing the risks relating to these factors, together with other risks incident to the operation of our business, our financial condition, results of operations and cash flows could be adversely affected. Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect the occurrence of unanticipated events.

**Overview**

The Company's net income for the quarter ended September 30, 2006 totaled \$4.8 million, an increase of 81.2% compared to \$2.6 million in the same quarter in 2005. Diluted earnings per share were \$0.27 for the quarter ended September 30, 2006 compared to \$0.28 per diluted share in the same quarter of 2005. Net income for the nine months ended September 30, 2006 totaled \$16.0 million, an increase of 135.9% compared to \$6.8 million in the same period in 2005. Diluted earnings per share were \$0.90 for the nine months ended September 30, 2006, a 23.3% increase compared to \$0.73 in the same period of 2005. With assets totaling \$1.78 billion, Flag Financial is the largest community banking company headquartered in metro Atlanta.

Total revenue was \$19.4 million and \$59.1 million for the quarter and nine months ended September 30, 2006, respectively. This represented increases of 52.0% and 66.8% over the same periods in 2005. Revenue growth is a result of both the acquisition and integration of First Capital Bank into Flag Bank and by strong internal growth. The successful integration of First Capital is reflected in the Company's efficiency ratio which improved to 61.59% and 57.08% for the third quarter and nine months ended September 30, 2006, respectively, compared to 67.76% and 70.06% in the same periods in 2005.

Loans outstanding increased \$44.1 million or 3.7% to \$1.25 billion as of September 30, 2006 from \$1.21 billion at December 31, 2005. At September 30, 2006, nonperforming loans to total loans decreased to 0.54% from 0.57% at December 31, 2005. The allowance for loan losses totaled \$17.2 million or 1.36% of loans at September 30, 2006 compared to \$16.8 million or 1.37% at December 31, 2005. Based upon asset quality key indicators and slower loan growth, the Company did not record loan loss provision in the third quarter ended September 30, 2006 compared to \$375,000 for the same period in 2005. For the nine months ended September 30, 2006, loan loss provision totaled \$550,000 compared to \$750,000 in the same period of 2005.

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Deposits increased \$66.6 million or 5.2% to \$1.35 billion at September 30, 2006, compared to \$1.28 billion at December 31, 2005. As the result of the Company's focus on attracting core deposits, core deposits increased \$39.0 million or 5.4% to \$763.6 million at September 30, 2006, compared to \$724.6 million at December 31, 2005. Its Smartstreet division successful cash management program has complemented the Company's deposit growth strategies. Smartstreet offers custom banking and cash management services for community associations and management companies.

#### **Recent Mergers and Acquisitions**

On August 9, 2006, Flag Financial Corporation and RBC Centura Banks, Inc. ( "RBC" ) entered into an Agreement and Plan of Merger (the "Merger Agreement" ) pursuant to which RBC will acquire Flag (the "Merger" ). Under the terms of the Merger Agreement, upon the closing of the transaction, each outstanding share of Flag common stock will be converted into cash in the amount of \$25.50 per share.

The Merger has been approved by the boards of directors of both Flag and RBC and is subject to the approval of the shareholders of Flag. In addition to shareholder approval, the Merger is subject to customary regulatory approvals in the United States and in Canada including approval by the Board of Governors of the Federal Reserve System. The Merger Agreement also includes customary representations, warranties, covenants and other closing conditions of both parties. Flag and RBC expect the Merger to close prior to the end of 2006.

In November 2005, Flag acquired 100 percent of the outstanding common shares of First Capital, a bank holding company headquartered in Norcross, Georgia. First Capital was the parent company of First Capital Bank, a community bank with five banking offices in the north metro Atlanta market. The merger accelerated Flag's strategy to continue to grow its presence in the metro Atlanta area. The consideration for the acquisition was a combination of cash and common stock with an aggregate purchase price of approximately \$137.6 million. The total consideration consisted of \$19.1 million in cash, approximately 6.9 million shares of Flag Financial common stock with a value of approximately \$112.7 million and 784,000 in stock options with a value of approximately \$5.8 million.

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##### **Critical Accounting Policies**

The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, we have made judgments, estimates and assumptions which, in the case of estimating our allowance for loan losses (ALL), have been critical to the determination of our financial position and results of operations. Management assesses the adequacy of the ALL regularly during the year, and formally prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance.

This estimation process can affect our estimated loan loss expense for a given period. Generally, the allowance for loan losses increases as the outstanding balance of loans or the level of classified or impaired loans increases. Loans or portions of loans that are deemed uncollectible are charged against and reduce the allowance. The allowance is replenished by means of a provision for loan losses that is charged as an expense. As a result, our estimate of the allowance for loan losses affects our earnings directly.

The ALL consists of two portions (1) allocated amounts representing the potential exposures on specifically identified credits and other exposures readily predictable by historical or comparative experience; and (2) an unallocated amount representative of inherent loss which is not readily identifiable. Even though the ALL is composed of two components, the entire ALL is available to absorb any credit losses. Allocated amounts are used on loans where management has determined that there is an increased probability or severity of loss than on the loan portfolio as a whole. We base the allocation for these unique loans primarily on risk rating grades assigned to each of these loans as a result of our loan management and review processes. We then assign each risk-rating grade a loss ratio, which is determined based on the experience of management, discussions with banking regulators and our independent loan review process. We estimate losses on impaired loans based on estimated cash flows discounted at the loan's original effective interest rate or based on the underlying collateral value. To the extent that management does not believe that a certain loan's risk is appropriately represented by the risk rating grades, a specific review of the credit is performed which would result in a specific allocation for that particular loan.

Unallocated amounts are particularly subjective and do not lend themselves to exact mathematical calculation. The unallocated amount represents estimated inherent credit losses which may exist, but have not yet been identified, as of the balance sheet date. In estimating the unallocated amount, we consider such matters as changes in the local or national economy, the depth or experience in the lending staff, any concentrations of credit in any particular industry group, and new banking laws or regulations. After we assess applicable factors, we evaluate the aggregate unallocated amount based on our management's experience. We then evaluate the resulting ALL balance by comparing the balance in the ALL to historical trends and peer information. Our management then evaluates the result of the procedures performed, including the result of our testing, and concludes on the appropriateness of the balance of the ALL in its entirety.

The audit committee of our board of directors reviews the assessment prior to the filing of quarterly and annual financial information. In assessing the adequacy of the ALL, we also rely on an ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process.

See "Provision and Allowance for Loan Losses" for additional information.

**Table of Contents****Flag Financial Corporation and Subsidiary****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Summary Financial Data**

The following table presents summary financial data for the previous five quarters (in thousands, except per share data).

| <i>(unaudited)</i>                            | Third<br>Quarter | 2006<br>Second<br>Quarter | First<br>Quarter | 2005<br>Fourth<br>Quarter | 2005<br>Third<br>Quarter |
|---|------------------|---------------------------|------------------|---------------------------|--------------------------|
| <b>Income Summary</b>                         |                  |                           |                  |                           |                          |
| Interest income                               | \$ 31,559        | \$ 30,761                 | \$ 28,272        | \$ 20,491                 | \$ 15,933                |
| Interest expense                              | 14,938           | 13,222                    | 11,946           | 8,688                     | 5,817                    |
| Net interest income                           | 16,621           | 17,539                    | 16,326           | 11,803                    | 10,116                   |
| Provision for loan losses                     |                  | 85                        | 465              |                           | 375                      |
| Noninterest income                            | 2,791            | 3,035                     | 3,332            | 1,235                     | 3,034                    |
| Noninterest expense                           | 11,872           | 11,448                    | 10,803           | 8,888                     | 8,855                    |
| Earnings before taxes                         | 7,540            | 9,041                     | 8,390            | 4,150                     | 3,920                    |
| Income taxes                                  | 2,762            | 3,233                     | 3,006            | 1,344                     | 1,283                    |
| Net income                                    | \$ 4,778         | \$ 5,808                  | \$ 5,384         | \$ 2,806                  | \$ 2,637                 |
| <b>Performance Ratios</b>                     |                  |                           |                  |                           |                          |
| Basic earnings per share                      | \$ 0.28          | \$ 0.34                   | \$ 0.32          | \$ 0.23                   | \$ 0.31                  |
| Diluted earnings per share                    | 0.27             | 0.33                      | 0.31             | 0.22                      | 0.28                     |
| Cash dividends declared                       | 0.06             | 0.06                      | 0.06             | 0.06                      | 0.06                     |
| Book value per share                          | 12.86            | 12.47                     | 12.41            | 12.14                     | 8.74                     |
| Return on average assets                      | 1.08%            | 1.31%                     | 1.25%            | 0.88%                     | 1.18%                    |
| Return on average equity                      | 8.86%            | 10.99%                    | 10.37%           | 8.65%                     | 14.46%                   |
| Return on average tangible equity(1)          | 18.96%           | 24.10%                    | 23.24%           | 15.87%                    | 20.17%                   |
| Net interest margin                           | 4.18%            | 4.47%                     | 4.32%            | 4.05%                     | 4.83%                    |
| Efficiency ratio                              | 61.59%           | 55.51%                    | 54.33%           | 68.68%                    | 67.76%                   |
| <b>Asset Quality</b>                          |                  |                           |                  |                           |                          |
| Allowance for loan losses                     | \$ 17,237        | \$ 17,337                 | \$ 17,360        | \$ 16,779                 | \$ 9,511                 |
| Nonperforming assets                          | 6,830            | 6,366                     | 7,301            | 6,937                     | 4,507                    |
| Allowance for loan losses to loans            | 1.36%            | 1.37%                     | 1.37%            | 1.37%                     | 1.36%                    |
| Nonperforming assets to total assets          | 0.38%            | 0.35%                     | 0.41%            | 0.41%                     | 0.49%                    |
| Net charge-offs (recoveries) to average loans | 0.03%            | 0.04%                     | (0.04)%          | (0.35)%                   | (0.13)%                  |
| <b>Average Balances</b>                       |                  |                           |                  |                           |                          |
| Loans outstanding, net                        | \$ 1,240,571     | \$ 1,229,557              | \$ 1,215,334     | \$ 903,240                | \$ 663,803               |
| Total assets                                  | 1,774,808        | 1,771,258                 | 1,725,282        | 1,276,883                 | 895,843                  |
| Deposits                                      | 1,340,942        | 1,350,382                 | 1,317,016        | 1,018,107                 | 765,055                  |
| Stockholders' equity                          | 215,683          | 211,369                   | 207,697          | 129,803                   | 72,921                   |
| Basic common shares outstanding:              | 17,003           | 16,924                    | 16,890           | 12,130                    | 8,546                    |
| Diluted common shares outstanding             | 17,848           | 17,666                    | 17,398           | 12,743                    | 9,275                    |
| <b>At Period End</b>                          |                  |                           |                  |                           |                          |
| Loans outstanding, net                        | \$ 1,249,140     | \$ 1,248,127              | \$ 1,247,511     | \$ 1,205,046              | \$ 691,488               |

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|                           |                  |           |           |           |         |
|---------------------------|------------------|-----------|-----------|-----------|---------|
| Total assets              | <b>1,776,142</b> | 1,794,461 | 1,770,645 | 1,702,861 | 919,125 |
| Deposits                  | <b>1,350,584</b> | 1,349,669 | 1,363,108 | 1,283,952 | 784,806 |
| Stockholders' equity      | <b>218,667</b>   | 212,095   | 209,625   | 204,800   | 74,652  |
| Common shares outstanding | <b>17,009</b>    | 17,002    | 16,893    | 16,874    | 8,546   |

(1) Tangible shareholders' equity is shareholders' equity less goodwill and intangible assets.

**Table of Contents****Flag Financial Corporation and Subsidiary****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****GAAP Reconciliation and Management Explanation of Non-GAAP Financial Measures**

Certain financial information included in the summary financial data is determined by methods other than in accordance with accounting principles generally accepted within the United States, or GAAP. These non-GAAP financial measures are, tangible shareholders' equity and return on average tangible equity. Flag's management uses these non-GAAP measures in its analysis of the Company's performance.

Tangible shareholders' equity is shareholders' equity less goodwill and other intangible assets.

Return on average tangible equity is defined as earnings for the period divided by average equity reduced by average goodwill and other intangible assets.

These disclosures should not be viewed as a substitute for results determined in accordance with GAAP, and are not necessarily comparable to non-GAAP performance measures which may be presented by other companies.

The following reconciliation table provides a more detailed analysis of tangible shareholders' equity and return on average tangible equity:

|                                   | 2006             |                   |                  | 2005              |                  |
|-----------------------------------|------------------|-------------------|------------------|-------------------|------------------|
|                                   | Third<br>Quarter | Second<br>Quarter | First<br>Quarter | Fourth<br>Quarter | Third<br>Quarter |
| Return on average equity          | 8.86%            | 10.99%            | 10.37%           | 8.65%             | 14.46%           |
| Effect of intangible assets       | 10.10%           | 13.11%            | 12.87%           | 7.22%             | 5.71%            |
| Return on average tangible equity | 18.96%           | 24.10%            | 23.24%           | 15.87%            | 20.17%           |

**Overview of Financial Condition**

Total assets were \$1.78 billion at September 30, 2006, an increase of \$73.3 million or 4.3% from \$1.70 billion at December 31, 2005. Interest-earning assets (consisting of loans, investment securities, other interest-bearing deposits in banks and short-term investments) totaled \$1.59 billion or 89.4% of total assets at September 30, 2006, compared to \$1.51 billion or 88.8% of total assets at December 31, 2005. During the same period, stockholders' equity increased \$13.9 million or 6.8% to \$218.7 million at September 30, 2006, compared to \$204.8 million at December 31, 2005.

**Loans**

Loans are reported at their outstanding unpaid balances, net of the allowance for loan losses, deferred loan fees and unamortized premiums or discounts on purchased loans. Balances within the major loans receivable categories are represented in the following table (in thousands):

|                                   | September 30,<br>2006 | % of<br>Total Loans | December 31,<br>2005 | % of<br>Total Loans | September 30,<br>2005 | % of<br>Total Loans |
|-----------------------------------|-----------------------|---------------------|----------------------|---------------------|-----------------------|---------------------|
| Commercial/financial/agricultural | \$ 135,460            | 10.7%               | \$ 126,293           | 10.3%               | \$ 92,457             | 13.2%               |
| Real estate - Construction        | 562,276               | 44.4%               | 448,336              | 36.7%               | 215,501               | 30.7%               |
| Real estate - Mortgage            | 554,895               | 43.8%               | 626,189              | 51.3%               | 376,877               | 53.8%               |
| Consumer installment loans        | 13,740                | 1.1%                | 20,961               | 1.7%                | 16,160                | 2.3%                |
| Lease financing                   | 6                     |                     | 46                   |                     | 4                     |                     |

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|                                 |                     |               |              |        |            |        |
|---------------------------------|---------------------|---------------|--------------|--------|------------|--------|
| Total loans                     | <b>1,266,377</b>    | <b>100.0%</b> | 1,221,825    | 100.0% | 700,999    | 100.0% |
| Less: Allowance for loan losses | <b>17,237</b>       |               | 16,779       |        | 9,511      |        |
| Total net loans                 | <b>\$ 1,249,140</b> |               | \$ 1,205,046 |        | \$ 691,488 |        |

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Loans outstanding, net, totaled \$1.25 billion at September 30, 2006, an increase of \$44.1 million or 3.7%, compared to \$1.21 billion at December 31, 2005. Construction loans increased \$113.9 million or 25.4% in the nine months ended September 30, 2006 compared to December 31, 2005. The increase in construction lending is primarily located in the metro Atlanta area. During the same nine month period, payoffs of commercial real estate loans have outpaced originations of new real estate mortgage loans. Real estate mortgage loans decreased \$71.3 million or 11.4% in the nine months ended September 30, 2006 compared to December 31, 2005. Loans outstanding, net, represented 78.7% and 79.7% of interest-earning assets at September 30, 2006 and December 31, 2005, respectively.

Flag engages in a full complement of lending activities, including permanent residential mortgage loans, permanent residential construction loans, commercial mortgage loans, commercial business loans, financial loans, agricultural loans and consumer installment loans. Flag concentrates its lending activities in several areas that management believes provides adequate diversification with acceptable yield and risk levels. These areas include, but are not limited to construction, commercial real estate, agricultural and correspondent lending (lending services to other community banks). The majority of Flag's real estate loans are secured by real property located in West-Central and Middle Georgia and metropolitan Atlanta, Georgia. While risk of loss is primarily tied to the credit quality of the various borrowers, risk of loss may also increase due to factors beyond Flag's control, such as local, regional and/or national economic downturns. General conditions in the real estate market may also impact the relative risk in the real estate portfolio. Of the target areas of lending activities, commercial and financial loans are generally considered to have a greater risk of loss than real estate loans or consumer installment loans. For more information see Management's Discussion and Analysis of Financial Condition and Results of Operations - Provision and Allowance for Loan Losses.

**Investment Securities**

Investment securities at September 30, 2006, totaled \$311.9 million, an increase of \$64.6 million or 26.2% from \$247.2 million at December 31, 2005. Investment securities comprised 19.6% and 16.4% of interest-earning assets at September 30, 2006 and December 31, 2005, respectively. During the nine months ended September 30, 2006, \$27.9 million in investment securities repaid and Flag purchased \$93.2 million in investment securities with a higher average yield. In addition, in the fourth quarter of 2005, Flag initiated a repositioning of its balance sheet designed to further reduce its exposure to an anticipated continued increase in interest rates and to improve net interest margin and net interest income levels. Flag sold \$67.6 million in fixed-rate investments and reinvested the proceeds in a combination of fixed-rate and variable rate investments with a higher average yield.

The composition of the investment securities portfolio reflects management's strategy of maintaining an appropriate combination of liquidity, interest-rate risk and yield. Flag seeks to maintain an investment portfolio with minimal credit risk, investing mostly in obligations of the United States Treasury or other state and federal governmental agencies or quasi-agencies. During the quarter and nine month period ended September 30, 2006, Flag did not experience any other-than-temporary impairment.

**Federal Funds Sold and Other Interest-bearing Deposits in Banks**

Short-term investments (federal funds sold and other interest-bearing deposits in banks) totaled \$159,000 at September 30, 2006, a decrease of \$25.1 million or 99.4% from \$25.3 million at December 31, 2005. Cash received from short-term investments was used to fund the growth in the loan and investment portfolios and to repay short-term debt.



**Table of Contents****Flag Financial Corporation and Subsidiary****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Premises and Equipment**

Premises and equipment at September 30, 2006, totaled \$14.7 million, an increase of \$683,000 or 4.9%, from \$14.0 million at December 31, 2005. In the first quarter of 2006, Flag sold its mortgage office in Columbus, Georgia, with a net book value of \$309,000 and recognized a pre-tax gain on the sale of \$219,000. In the second quarter of 2006, Flag purchased an office building in Macon, Georgia, for \$746,000. The Company plans to open a full-service banking and loan production office in this facility.

**Deposits and Other Funding**

Total deposits at September 30, 2006, were \$1.35 billion, an increase of \$66.6 million or 5.2% from \$1.28 billion at December 31, 2005. Core deposits offer the Bank a lower cost source of funds. Core deposits (noninterest-bearing demand, interest-bearing demand, money market and savings accounts) were \$763.6 million at September 30, 2006, compared to \$724.6 million at December 31, 2005. Core deposits comprise 56.5% of the total deposit base at September 30, 2006 versus 56.4% at December 31, 2005. Noninterest-bearing deposits grew \$24.3 million to \$197.0 million at September 30, 2006 compared to \$172.7 million at December 31, 2005. The increase in non-interest bearing deposits is largely due to the success of the Smartstreet cash management program. Smartstreet offers custom banking and cash management services for community associations and management companies.

Time deposits, which are the most expensive type of deposit funding, increased \$27.7 million or 4.9% to \$587.0 million at September 30, 2006 compared to \$559.3 million at December 31, 2005. Time deposits comprised 43.5% of the total deposit base at September 30, 2006 compared to 43.6% at December 31, 2005. Total deposits represented 87.8% of funding sources at September 30, 2006 compared to 86.9% at December 31, 2005.

**Advances from the Federal Home Loan Bank**

Advances from the Federal Home Loan Bank ( FHLB ) declined \$13.2 million or 9.2% to \$130.3 million at September 30, 2006 compared to \$143.5 million at December 31, 2005. FHLB borrowings represented 8.5% of funding sources at September 30, 2006 compared to 9.7% at December 31, 2005.

FHLB advances as of September 30, 2006 and December 31, 2005 are as follows:

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| FHLB advances, interest payable at fixed rates ranging from 4.51% to 5.92%; advances mature at various maturity dates from October 24, 2007 through January 17, 2012; weighted average rate at September 30, 2006 is 4.97%.    | \$ 14,005             | \$ 13,878            |
| FHLB advances, interest payable at variable rates ranging from 4.55% to 5.46%; advances mature at various maturity dates from September 17, 2007 through April 25, 2012; weighted average rate at September 30, 2006 is 5.00%. | 116,286               | 129,591              |
|  | <b>\$ 130,291</b>     | <b>\$ 143,469</b>    |

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### **Flag Financial Corporation and Subsidiary**

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

##### **Federal Funds Purchased and Repurchase Agreements**

Federal funds purchased and repurchase agreements increased \$5.7 million or 137.1% to \$9.8 million at September 30, 2006 from \$4.1 million at December 31, 2005. Federal funds purchased and repurchase agreements represented 0.6% of funding sources at September 30, 2006 versus 0.3% at December 31, 2005. Federal funds purchased were used to fund loans.

##### **Junior Subordinated Debentures**

Junior subordinated debentures remained at \$46.8 million at September 30, 2006 and December 31, 2005. Junior subordinated debentures represented 3.0% of funding sources at September 30, 2006 versus 3.2% at December 31, 2005. For more information see Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital.

##### **Liquidity Management and Funding Sources**

Liquidity management involves Flag's ability to maintain adequate short-term assets to meet the cash flow expectations of depositors and other lending institutions and to provide funds for the growth in interest-earning assets on a timely and cost effective basis. Liquidity is managed daily by understanding the cash flow expectations of depositors and other lending institutions and maintaining enough liquid assets to meet these expectations.

Liquid assets (assets that can be easily converted to cash) at September 30, 2006, totaled \$129.6 million and included cash and due from banks, and other interest-bearing deposits, unpledged investment securities available-for-sale and mortgage loans held-for-sale.

Deposits provide a significant portion of the Company's cash flow needs and continue to provide a relatively stable, low cost source of funds. As of September 30, 2006, Flag had \$302.0 million of deposits due on demand, \$443.8 million in money market deposits, \$17.8 million in savings deposits and \$527.0 million of time deposits and other borrowings due within one year. Other funding sources readily available to the Company are purchased funds, including wholesale funding sources. Wholesale funding sources include advances from the FHLB, federal funds purchased and securities sold under agreements to repurchase. Flag maintains available lines of credit with other financial institutions. These include federal funds and other lines of credit totaling \$91.0 million and a line of credit with the FHLB totaling \$355.0 million at September 30, 2006. Flag also maintains a line of credit with the Federal Reserve Bank of Atlanta (the FRB) totaling \$250.6 million at September 30, 2006. At September 30, 2006, of the \$696.5 million in total lines, \$561.7 million is still available to Flag. The available commitment level varies proportional to the collateral balances for the FHLB and FRB lines of credit. Flag's internal policy is to limit brokered certificates of deposits to no more than 40% of total assets, without prior approval of the Board of Directors. At September 30, 2006, brokered certificates of deposit totaled \$125.2 million or 7.1% of total assets.

Cash flows from operations are also a source of liquidity. Net cash from operations results primarily from net income adjusted for certain items such as depreciation and amortization, provision for loan losses, gains on the sale of investments in real estate and timing differences from the sale of loans held-for-sale versus originations of loans held-for-sale.

**Table of Contents****Flag Financial Corporation and Subsidiary****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Off-Balance Sheet Arrangements**

Flag is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. Flag's exposure to credit loss in the event of non-performance by the other party to the instrument is represented by the contractual notional amount of the instrument.

Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Flag uses the same credit policies in making commitments to extend credit as they do for on-balance sheet instruments. Collateral held for commitments to extend credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes Flag's off-balance sheet financial instruments whose contract amounts represent credit risk as of September 30, 2006 and December 31, 2005 (in thousands):

|                              | 2006       | 2005       |
|------------------------------|------------|------------|
| Commitments to extend credit | \$ 382,693 | \$ 398,512 |
| Standby letters of credit    | \$ 6,096   | \$ 13,670  |

**Market Risk Sensitivity**

Market rate sensitivity is the tendency for changes in the interest rate environment to be reflected in Flag's net interest income and results of operations. Flag, through its asset and liability management program, seeks to balance maturities and rates on interest-earning assets and the corresponding funding such that interest rate fluctuations have a minimal impact on earnings and the value of Flag's equity.

Historically, the average term to maturity or repricing (rate changes) of assets (primarily loans and investment securities) has exceeded the average repricing period of liabilities (primarily deposits and borrowings). Flag's primary source of funding has been demand and money market deposits (interest-bearing and noninterest-bearing) instead of time deposits and wholesale borrowings with longer maturities. This method of funding interest-earning assets has issues concerning interest rate risk, liquidity and profitability, all of which were contemplated and measured by the Company. Flag concluded that this strategy is the most profitable method of funding growth in interest-earning assets of the Company for the foreseeable future and has committed significant sales, marketing and training resources at being successful in this effort. Where interest rate risk is concerned, Flag considered factors such as account size, relationship strength and historical rate levels needed to remain competitive. Generally speaking, it is the opinion of management that these deposits are less sensitive to rate movements than the interest-earning assets they are funding. Flag uses an interest rate simulation model that uses management assumptions and theories regarding rate movements and the impact each movement will have on individual components of the balance sheet. As of September 30, 2006, Flag's simulation model shows that Flag's balance sheet is asset-sensitive, meaning a rising rate environment would have a positive impact on Flag's net interest income. The Company uses three standard scenarios—rates unchanged, rising rates, and declining rates—in analyzing interest rate sensitivity. At September 30, 2006, Flag's simulation model indicated that a 100 basis points increase or decrease over the next twelve months would increase net interest income approximately 4.63%, and decrease net interest income approximately 6.54% in the rising and declining rate scenarios, respectively, versus the projection under unchanged rates. The interest rate simulation model assumes a yield curve that is positively sloped (higher rates for longer maturities).

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Currently, the inversion in the yield curve is causing a detrimental impact on the Company's net interest income compared to the forecasted net interest income under a positively sloped yield curve. A significant part of the Company's loan portfolio is tied to Prime Rate and with no increase in the Federal Reserve discount rate in the third quarter ended September 30, 2006, these loans did not reprice. At the same time, the Company's time deposits continued to reprice at maturity, thus compressing net interest income.

Management carefully measures and monitors market rate sensitivity and believes that its operating strategies offer protection against interest rate risk. As required by various regulatory authorities, Flag's Board of Directors established an interest rate risk policy, which sets specific limits on interest rate risk exposure. Adherence to this policy is reviewed by Flag's executive committee and presented at least annually to the Board of Directors.

Flag's management from time to time uses certain derivative instruments in an effort to add stability to the Company's net interest income and manage exposure to changing interest rates. All derivatives are classified as either fair value hedges (those designed to hedge the fair market value of asset or liabilities affected by changing interest rates) or cash flow hedges (those designed to mitigate exposure to variability in expected future cash flows due to changing interest rates).

At September 30, 2006, the Company had interest rate floors and an interest rate corridor designated as cash flow hedges. No fair value hedges were outstanding. The following tables summarize the outstanding derivative instruments (in thousands):

**Interest Rate Floors**

| Type                              | Transaction Date | Term     |      | Notional   | Strike Rate | Current Rate | Fair Value |
|-----------------------------------|------------------|----------|------|------------|-------------|--------------|------------|
|                                   |                  | Date     | Date |            |             |              |            |
| Prime Based Floorlets             | May 2005         | May 2008 |      | \$ 50,000  | 5.50%       | 8.25%        | \$ 6       |
| Prime Based Floorlets             | May 2005         | May 2010 |      | 50,000     | 5.50%       | 8.25%        | 79         |
| <b>Total Interest Rate Floors</b> |                  |          |      | \$ 100,000 | 5.50%       | 8.25%        | \$ 85      |

| Type                   | Transaction Date | Term     |      | Notional | Cap Purchased | Cap Sold | Fair Value |
|------------------------|------------------|----------|------|----------|---------------|----------|------------|
|                        |                  | Date     | Date |          |               |          |            |
| Interest Rate Corridor | Nov 2002         | Nov 2007 |      | \$ 5,000 | 4.00%         | 7.00%    | \$ 74      |

As of September 30, 2006, the change in net unrealized gains of \$256,000, pretax, for derivatives designated as cash flow hedges is separately disclosed in accumulated other comprehensive income. For cash flow hedges, losses on derivative contracts reclassified from accumulated other comprehensive income to current period earnings are included in the line item in the Consolidated Statement of Earnings in which the hedged item is recorded and in the same period the hedged item affects earnings.

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As of September 30, 2006, Flag determined its interest swap was ineffective and recorded a loss for the third quarter and nine months ended September 30, 2006, totaling \$27,000.

The following table summarizes the ineffective swap (in thousands):

**Interest Rate Swap**

| Type   | Transaction<br>Date | Term<br>Date | Notional | Receive<br>Rate | Pay<br>Rate | Fair  |
|--|---------------------|--------------|----------|-----------------|-------------|-------|
|  |                     |              |          |                 |             | Value |
| <b>Receive Fixed, Pay LIBOR Swap<br/>Capital</b> | June 2004           | Dec 2006     | \$ 5,000 | 3.27%           | 5.32375%    | (27)  |

At September 30, 2006, the capital ratios of Flag and the Bank met all regulatory capital requirements to be well capitalized. Minimum ratios required for holding companies and banks to ensure capital adequacy are 8% for total capital to risk weighted assets and 4% each for Tier 1 capital to average assets. Minimum ratios required for holding companies and banks to be well capitalized under prompt corrective action provisions are 10% for total capital to risk weighted assets, 6% for Tier 1 capital to risk weighted assets and 5% for Tier 1 capital to average assets.

The Company has four statutory trusts which offered and sold Preferred Securities. The proceeds of such issuances, together with the proceeds of the related issuance of common securities of each trust were invested in junior subordinated debentures. Flag has outstanding junior subordinated debentures totaling \$46.8 million at September 30, 2006.

The following table reflects Flag's capital position with respect to the regulatory minimums as of September 30, 2006 (in thousands):

|  | Actual<br>Amount | %      | Required<br>Amount | %     | Excess<br>Amount | %     |
|--|------------------|--------|--------------------|-------|------------------|-------|
| Total Capital (to Risk Weighted Assets)  | \$ 166,153       | 12.50% | \$ 106,307         | 8.00% | \$ 59,846        | 4.50% |
| Tier 1 Capital (to Risk Weighted Assets) | \$ 149,161       | 11.22% | \$ 53,154          | 4.00% | \$ 96,007        | 7.22% |
| Tier 1 Capital (to Average Assets)       | \$ 149,161       | 8.99%  | \$ 66,400          | 4.00% | \$ 82,761        | 4.99% |

**Provision and Allowance for Loan Losses**

For the quarter ended September 30, 2006, net charge-offs totaled \$100,000 compared to net recoveries of \$221,000 in the quarter ended September 30, 2005. Net charge-offs to average loans were 0.03% compared to net recoveries to average loans of 0.13% for the quarters ended September 30, 2006 and 2005, respectively. Net charge-offs for the nine months ended September 30, 2006, equaled \$92,000 compared to net recoveries of \$159,000 in the same period last year. Based upon asset quality key indicators and slower loan growth in the current quarter, management determined that the level of the allowance for loan losses was adequate at September 30, 2006 and there was no loan loss provision recorded during the third quarter of 2006. Loan loss provision for the nine months ended September 30, 2006 totaled \$550,000. Loan loss provision for the quarter and nine months ended September 30, 2005, was \$375,000 and \$750,000, respectively.

The allowance for loan losses is established through provisions for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collection of the principal is unlikely. The allowance is an amount which, in management's judgment, will be adequate to absorb losses on existing loans that may become uncollectible.



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The allowance for loan losses totaled \$17.2 million at September 30, 2006, compared to \$16.8 million at December 31, 2005. The allowance for loan losses to loans outstanding remained relatively stable at 1.36% at September 30, 2006 compared to 1.37% at December 31, 2005. The ratio of the allowance for loan losses to nonperforming loans decreased slightly to 2.80 times at September 30, 2006 from 2.89 times at December 31, 2005. Management considered the level of charge-offs and nonperforming loans, as well as the mix of nonperforming loans, in determining the level of allowance for loan losses.

An allocation of the allowance for loan losses has been made according to the respective amounts deemed necessary to provide for the probability of incurred losses within the various loan categories. Although other relevant factors are considered, management believes that the level of loan loss allowance at September 30, 2006, was adequate based primarily on previous charge-off experience, adjusted for risk characteristics associated with changes in the composition and growth in the loan portfolio, the specific circumstances of the concentrations in the nonaccrual loans and loans past due 90 days and still accruing, including the market value of collateral and economic conditions that may affect the borrowers' ability to repay and such other factors which, in management's judgment, deserve recognition under existing economic conditions.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review Flag's allowance for loan losses. Such agencies may require Flag to recognize additions to the allowance based on their judgments about information available to them at the time of their examination. For more information see Management's Discussion and Analysis of Financial Condition and Results of Operation - Nonperforming Assets.

The following table presents an analysis of the allowance for loan losses for the three and nine month periods ended (in thousands):

|   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2006                                | 2005     | 2006                               | 2005     |
| Balance of allowance for loan losses at beginning of period | \$ 17,337                           | \$ 8,915 | \$ 16,779                          | \$ 8,602 |
| Provision charged to operating expense                      |                                     | 375      | 550                                | 750      |
| Charge-offs:  |                                     |          |                                    |          |
| Commercial  | (53)                                |          | (148)                              | (266)    |
| Real estate - mortgage                                      | (89)                                | (39)     | (305)                              | (46)     |
| Consumer installment loans                                  | (20)                                | (24)     | (49)                               | (55)     |
| Lease financing   |                                     | (1)      |                                    | (1)      |
| Total charge-offs   | (162)                               | (64)     | (502)                              | (368)    |
| Recoveries:   |                                     |          |                                    |          |
| Commercial  | 7                                   | 38       | 45                                 | 163      |
| Real estate - mortgage                                      | 24                                  | 238      | 315                                | 328      |
| Consumer installment loans                                  | 31                                  | 9        | 50                                 | 36       |
| Total recoveries  | 62                                  | 285      | 410                                | 527      |
| Net (charge-offs) recoveries                                | (100)                               | 221      | (92)                               | 159      |
| Balance of allowance for loan losses at end of period       | \$ 17,237                           | \$ 9,511 | \$ 17,237                          | \$ 9,511 |

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See [Critical Accounting Policies](#) for an explanation of our methodology for determining the appropriate level for the allowance and its effect on our results of operations.



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Flag's solid credit quality is reflected in its credit quality ratios. Nonperforming assets (nonaccrual loans, other real estate owned and repossessions) totaled \$6.8 million at September 30, 2006, compared to \$6.9 million at December 2005. Nonperforming assets to total assets were 0.38% at September 30, 2006, compared to 0.41% at December 31, 2005. Nonaccrual loans increased to \$6.2 million at September 30, 2006, from \$5.7 million at December 31, 2005. Loans past due 90 days and still accruing and other real estate owned decreased to \$5,000 and \$664,000, respectively, at September 30, 2006, from \$120,000 and \$1.1 million, respectively, at December 31, 2005.

Flag has a loan review function that continually monitors selected accruing loans for which general economic conditions or changes within a particular industry could cause the borrowers financial difficulties. The loan review function also identifies loans with high degrees of credit or other risks. The focus of loan review is to maintain a low level of nonperforming assets and to return current nonperforming assets to earning status.

Flag's strong credit quality is attributed to a combination of Flag's strict credit culture that focuses more heavily on the quality of the borrower's financial condition and collateral values, a comprehensive loan review program and strict management of problem assets. At September 30, 2006, there were no commitments to advance additional funds on any loan classified as nonaccrual.

The following table summarizes the nonperforming assets for the periods presented (in thousands):

|  | September 30,<br>2006 | December 31,<br>2005 | September 30,<br>2005 |
|--|-----------------------|----------------------|-----------------------|
| Loans on nonaccrual  | \$ 6,161              | \$ 5,694             | \$ 3,411              |
| Loans past due 90 days and still accruing                  | 5                     | 120                  | 49                    |
| Other real estate owned and repossessions                  | 664                   | 1,123                | 1,047                 |
| Total nonperforming assets                                 | \$ 6,830              | \$ 6,937             | \$ 4,507              |
| Total nonperforming assets as a percentage of total assets | 0.38%                 | 0.41%                | 0.49%                 |

The \$6.2 million in nonaccrual loans at September 30, 2006 included \$3.8 million in Small Business Association (SBA) loans, of which SBA guaranteed \$3.0 million. This compares to nonaccrual SBA loans of \$2.4 million at December 31, 2005, of which SBA guaranteed \$2.0 million.

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**Table of Contents****Flag Financial Corporation and Subsidiary****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Results of Operations for the Three Month Periods Ended September 30, 2006 and 2005**

**Net income** Net income for the quarter ended September 30, 2006, was \$4.8 million, an increase of 81.2% compared to \$2.6 million in the same quarter in 2005. Diluted earnings per share were \$0.27 for the third quarter of 2006 compared to \$0.28 per diluted share in the same quarter in 2005. Net income includes pre-tax merger-related charges. For the quarter ended September 30, 2006, merger-related charges were \$359,000. Merger-related charges were incurred in connection with the impending merger with RBC and were primarily for investment banking, legal and other professional charges. For more information on the merger between Flag and RBC see Note 2 to the Consolidated Financial Statements Mergers and Acquisitions.

**Net interest income** Net interest income for the quarter ended September 30, 2006, was \$16.6 million, an increase of \$6.5 million or 64.3% from \$10.1 million for the third quarter of 2005. Flag's net interest margin (net interest income on a taxable-equivalent basis divided by average interest-earning assets) decreased 65 basis points to 4.18% from 4.83% on average interest-earning assets of \$1.59 billion and \$838.5 million for the quarters ended September 30, 2006 and September 30, 2005, respectively. The net interest margin decreased in the quarter ended September 30, 2006, compared to the third quarter of 2005, primarily due to the inclusion of First Capital's lower yielding loan portfolio and tighter spreads resulting from the continued flattening/inversion of the yield curve. While both short-term and long-term interest rates have risen for the last year, the yield curve has flattened considerably with short-term rates rising more rapidly. The Federal Reserve has increased the discount rate six times since September 30, 2005, increasing the rate from 3.75% to 5.25% over the past twelve months. The Federal Reserve did not increase the discount rate during the quarter ended September 30, 2006, causing a downward pressure on the Company's net interest margin as the increase in the cost of interest-bearing liabilities exceeded the increase in the yield on interest-earning assets. The impact is evident in the decline in the net interest margin of 29 basis points during the third quarter ended September 30, 2006 compared to the second quarter of 2006. The Company continues to focus on core deposit growth as a lower cost funding source. For the quarter ended September 30, 2006, the cost of core deposits increased 42 basis points compared to the increase in the cost of short-terming borrowings of 220 basis points. For more information on Flag's asset and liability management program see Management's Discussion and Analysis of Financial Condition and Results of Operation - Market Risk Sensitivity.

**Interest income** - Interest income for the quarter ended September 30, 2006, was \$31.6 million, an increase of \$15.7 million or 98.1% compared to \$15.9 million in the same quarter in 2005. The increase is primarily due to higher levels of average interest-earning assets. Increases in average interest-earning assets are a result of the merger with First Capital and continued strong internal growth. An increase in the yield on interest-earning assets also contributed to the improvement in interest income. The taxable equivalent yield on interest-earning assets increased 32 basis points to 7.91% in the quarter ended September 30, 2006, compared to 7.59% in the same quarter of 2005.

Interest income and fees on loans increased \$12.9 million or 90.7% to \$27.2 million for the quarter ended September 30, 2006, compared to \$14.3 million in the same quarter last year. The increase in interest income in the quarter ended September 30, 2006 was primarily a result of the growth in average loans. Average loans outstanding, including mortgage loans held-for-sale, during the quarter ended September 30, 2006, increased \$582.3 million or 85.0% to \$1.27 billion compared to \$684.7 million for the same quarter in 2005. The yield on loans in the quarter ended September 30, 2006, was 8.54%, an increase of 24 basis points from 8.30% in the same quarter last year. The increase in yield is primarily attributable to re-pricing of the adjustable rate loan portfolio as a result of the rising rate environment. Increases in interest rates during the 12 month period ended September 30, 2006, were largely offset by the inclusion of the First Capital lower yielding loan portfolio.

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Interest on investment securities increased \$2.9 million or 214.3%, to \$4.2 million for the quarter ended September 30, 2006 from \$1.3 million in the third quarter of 2005. The increase in interest income in the quarter ended September 30, 2006 was driven both by higher levels of average investment securities and an increase in the yield. In the quarter ended September 30, 2006, average investment securities increased \$198.3 million or 170.7%, to \$314.5 million compared to \$116.2 million in the same quarter of 2005. The taxable equivalent yield on investment securities increased 65 basis points to 5.41% in the quarter ended September 30, 2006 compared to 4.76% in the same quarter of 2005. During the nine months ended September 30, 2006, \$27.9 million in investment securities repaid and Flag purchased \$93.2 million in investment securities with a higher average yield. In addition, in the fourth quarter of 2005, Flag initiated a repositioning of its balance sheet designed to further reduce its exposure to an anticipated continued increase in interest rates and to improve net interest margin and net interest income levels. Flag sold \$67.6 million in fixed-rate investments and reinvested the proceeds in a combination of fixed-rate and variable rate investments with a higher average yield.

Interest on federal funds sold and other interest-bearing deposits in banks decreased \$197,000 or 62.5% in the quarter ended September 30, 2006, to \$118,000 from \$315,000 in the third quarter of 2005. Interest on federal funds sold and other interest-bearing deposits decreased as a result of a decline in the average balance of federal funds sold and other interest-bearing deposits in banks. During the quarter ended September 30, 2006, the average balance of federal funds sold and other interest-bearing deposits in banks declined \$28.9 million or 76.7% compared to the third quarter of 2005, while the cost increased 203 basis points as a result of the impact of the rise in the discount rate over the past 12 months. During the quarter ended September 30, 2006, federal funds sold and other interest-bearing deposits in banks were used to fund loans and repay short-term borrowings.

**Interest expense** Interest expense for the quarter ended September 30, 2006, was \$14.9 million, an increase of \$9.1 million or 156.8% from \$5.8 million in the same quarter in 2005. The increase is due to higher levels of average interest-bearing liabilities coupled with a rising interest rate environment. Increases in average interest-bearing liabilities are a result of the merger with First Capital and continued strong internal growth. In the quarter ended September 30, 2006, average interest-bearing liabilities increased \$579.9 million or 84.8% to \$1.34 billion from \$757.6 million in the third quarter of 2005. Flag's total cost of interest-bearing liabilities increased 138 basis points to 4.43% from 3.05% over the same period last year, compared to a 150 basis point increase in the discount rate from September 30, 2005 to September 30, 2006. The increase reflects the impact of higher rates on variable rate borrowings and increases in deposit pricing.

Interest expense on deposits increased \$7.0 million or 132.6% to \$12.2 million in the quarter ended September 30, 2006, from \$5.2 million in the third quarter of 2005. The increase is due to both an increase in the average balance and cost of interest-bearing deposits. Average core deposits (noninterest-bearing, demand, money market and savings) in the quarter ended September 30, 2006, were \$766.3 million, an increase of \$342.4 million or 80.8%, from \$423.9 million in the third quarter of 2005. Core deposits offer the Bank a lower cost source of funds. The cost of core deposits increased 42 basis points to 2.64% in the quarter ended September 30, 2006 compared to 2.22% in the same period last year. Average noninterest-bearing demand deposits increased \$144.2 million or 254.7% to \$200.8 million in the quarter ended September 30, 2006 compared to \$56.6 million in the same period last year. This increase in noninterest-bearing deposits was consistent with Flag's strategic intent to increase core deposits as a lower cost source of funding. Average time deposits in the quarter ended September 30, 2006, were \$574.6 million, an increase of \$233.5 million or 68.5% from \$341.1 million in the third quarter of 2005. The cost of time deposits increased 156 basis points to 4.88% in the quarter ended September 30, 2006 compared to 3.32% in the same period in 2005. The increase in the cost of deposits is primarily attributable to increased pricing of Flag's deposit products as a result of the rising rate environment.

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Interest expense on FHLB advances and other borrowings for the quarter ended September 30, 2006, was \$1.7 million, an increase of \$1.5 million or 619.8%, from \$237,000 for the same quarter of 2005. Average FHLB advances and other borrowings in the quarter ended September 30, 2006, were \$138.8 million, an increase of \$112.4 million or 425.8%, from \$26.4 million in the same quarter of 2005. The increase in average FHLB advances is a result of the merger with First Capital. The cost of FHLB advances and other borrowings increased 132 basis points to 4.88% in the quarter ended September 30, 2006 from 3.56% in the same quarter of 2005. The increase in the cost of FHLB advances and other borrowings reflects the impact of the rising rate environment on the adjustable rate advances.

Interest expense on federal funds purchased and repurchase agreements for the quarter ended September 30, 2006, was \$160,000, an increase of \$149,000 or 1354.5%, from \$11,000 for the same quarter of 2005. The increase is attributable to higher levels of short-term borrowings and an increase in the cost of short-term borrowings. Average federal funds purchased and repurchase agreements in the quarter ended September 30, 2006, were \$11.9 million, an increase of \$10.5 million or 753.6%, from \$1.4 million in the same quarter of 2005. The cost of these borrowings increased 220 basis points to 5.34% in the quarter ended September 30, 2006 from 3.14% in the same quarter of 2005. The increase in the cost is attributable to the rising rate environment.

Interest expense on junior subordinated debt was \$903,000 for the quarter ended September 30, 2006, an increase of \$565,000 or 167.2% from \$338,000 for the same quarter of 2005. Average junior subordinated debentures increased \$25.4 million or 118.8%, to \$46.8 million in the quarter ended September 30, 2006 compared to \$21.4 million in the same quarter of 2005. In 2005, the Company issued \$25.8 million in junior subordinated debt to finance the merger with First Capital and for other general operating expenses. In addition, through its acquisition of First Capital in the fourth quarter of 2005, the Company recorded \$6.6 million in junior subordinated debt. The cost of junior subordinated debentures increased 139 basis points to 7.66% in the quarter ended September 30, 2006 compared to 6.27% in the third quarter of 2005. The increase in the cost of junior subordinated debentures is attributable to the rising rate environment and the related effect on the variable rate coupons.

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The following tables reflect the average balances, the interest income or expense and the average yield and cost of the Company's interest-earning assets and interest-bearing liabilities during the three month periods presented (dollars in thousands):

**Consolidated Average Balance Sheets**

|   | Three Months Ended September 30, |                         |                       |                   |                         |                       |
|---|----------------------------------|-------------------------|-----------------------|-------------------|-------------------------|-----------------------|
|   | 2006                             |                         |                       | 2005              |                         |                       |
|   | Average Balance                  | Interest Income/Expense | Weighted Average Rate | Average Balance   | Interest Income/Expense | Weighted Average Rate |
| <b>Assets:</b>                                    |                                  |                         |                       |                   |                         |                       |
| Loans <sup>(1)</sup>                              | \$ 1,266,973                     | \$ 27,276               | 8.54%                 | \$ 684,706        | \$ 14,326               | 8.30%                 |
| Taxable investment securities                     | 302,112                          | 4,076                   | 5.35%                 | 108,547           | 1,252                   | 4.58%                 |
| Tax-exempt investment securities <sup>(1)</sup>   | 12,354                           | 215                     | 6.90%                 | 7,630             | 141                     | 7.33%                 |
| Other interest-bearing deposits in banks          | 697                              | 8                       | 4.55%                 | 18,322            | 153                     | 3.31%                 |
| Federal funds sold                                | 8,051                            | 110                     | 5.42%                 | 19,277            | 162                     | 3.33%                 |
| <b>Total interest-earning assets</b>              | <b>1,590,187</b>                 | <b>\$ 31,685</b>        | <b>7.91%</b>          | <b>838,482</b>    | <b>\$ 16,034</b>        | <b>7.59%</b>          |
| Noninterest-earning assets                        | 184,621                          |                         |                       | 57,361            |                         |                       |
| <b>Total assets</b>                               | <b>\$ 1,774,808</b>              |                         |                       | <b>\$ 895,843</b> |                         |                       |
| <b>Liabilities and stockholders' equity:</b>      |                                  |                         |                       |                   |                         |                       |
| Interest-bearing demand deposits                  | \$ 96,811                        | \$ 271                  | 1.11%                 | \$ 76,031         | \$ 209                  | 1.09%                 |
| Money market                                      | 449,796                          | 4,797                   | 4.23%                 | 270,180           | 2,130                   | 3.13%                 |
| Savings deposits                                  | 18,899                           | 33                      | 0.69%                 | 21,120            | 35                      | 0.66%                 |
| Time deposits                                     | 574,620                          | 7,068                   | 4.88%                 | 341,115           | 2,857                   | 3.32%                 |
| <b>Total interest-bearing deposits</b>            | <b>1,140,126</b>                 | <b>12,169</b>           | <b>4.23%</b>          | <b>708,446</b>    | <b>5,231</b>            | <b>2.93%</b>          |
| FHLB advances and other borrowings                | 138,752                          | 1,706                   | 4.88%                 | 26,391            | 237                     | 3.56%                 |
| Federal funds purchased and repurchase agreements | 11,882                           | 160                     | 5.34%                 | 1,392             | 11                      | 3.14%                 |
| Junior subordinated debentures                    | 46,786                           | 903                     | 7.66%                 | 21,381            | 338                     | 6.27%                 |
| <b>Total interest-bearing liabilities</b>         | <b>1,337,546</b>                 | <b>\$ 14,938</b>        | <b>4.43%</b>          | <b>757,610</b>    | <b>\$ 5,817</b>         | <b>3.05%</b>          |
| Noninterest-bearing demand deposits               | 200,816                          |                         |                       | 56,609            |                         |                       |
| Noninterest-bearing liabilities                   | 20,763                           |                         |                       | 8,703             |                         |                       |
| Stockholders' equity                              | 215,683                          |                         |                       | 72,921            |                         |                       |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 1,774,808</b>              |                         |                       | <b>\$ 895,843</b> |                         |                       |
| Net interest rate spread                          |                                  | \$ 16,747               | 3.48%                 |                   | \$ 10,217               | 4.54%                 |
| Taxable-equivalent adjustment                     |                                  | 126                     |                       |                   | 101                     |                       |
| Net interest income, actual                       |                                  | \$ 16,621               |                       |                   | \$ 10,116               |                       |

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|   |            |         |           |         |
|---|------------|---------|-----------|---------|
| Net interest-earning assets/net interest margin                         | \$ 252,641 | 4.18%   | \$ 80,872 | 4.83%   |
| Interest-earning assets as a percentage of interest-bearing liabilities |            | 118.89% |           | 110.67% |

(1) Tax equivalent basis.

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The following table shows the change in net interest income for the three month periods presented due to changes in volumes and rates (in thousands):

**Rate/Volume Variance Analysis Taxable Equivalent Basis**

|   | <b>Three months ended September 30,<br/>2006 Compared to 2005</b> |                        |                       |
|---|---|------------------------|-----------------------|
|   | <b>Volume</b>   | <b>Rate/<br/>Yield</b> | <b>Net<br/>Change</b> |
| <b>Interest income:</b>                           |   |                        |                       |
| Loans   | \$ 12,535   | \$ 415                 | \$ 12,950             |
| Taxable investment securities                     | 2,611   | 213                    | 2,824                 |
| Tax-free investment securities                    | 82  | (8)                    | 74                    |
| Interest-bearing deposits in banks                | (202)   | 1 57                   | (145)                 |
| Federal funds sold                                | (153)   | 101                    | (52)                  |
| <b>Total interest income</b>                      | <b>14,873</b>   | <b>778</b>             | <b>15,651</b>         |
| <b>Interest expense:</b>                          |   |                        |                       |
| Interest-bearing demand deposits                  | 58  | 4                      | 62                    |
| Money market                                      | 1,916   | 751                    | 2,667                 |
| Savings deposits                                  | (4)   | 2                      | (2)                   |
| Time deposits                                     | 2,872   | 1,339                  | 4,211                 |
| FHLB advances and other borrowings                | 1,382   | 87                     | 1,469                 |
| Federal funds purchased and repurchase agreements | 141   | 8                      | 149                   |
| Junior subordinated debentures                    | 490   | 75                     | 565                   |
| <b>Total interest expense</b>                     | <b>6,855</b>  | <b>2,266</b>           | <b>9,121</b>          |
| <b>Net interest income</b>                        | <b>\$ 8,018</b>   | <b>\$ (1,488)</b>      | <b>\$ 6,530</b>       |

The increase in volume is due to the merger with First Capital and internal growth. The decrease in the rate/yield is primarily due to the influence of First Capital lower yielding loan portfolio coupled with the effects of a flat to inverted yield curve during 2006.

**Noninterest income** Noninterest income for the quarter ended September 30, 2006 decreased \$243,000 or 8.0% to \$2.8 million compared to \$3.0 million in the same quarter of 2005. Traditionally service charges on deposit accounts and revenues from mortgage banking activities have been the largest components of noninterest income.

Service charges on deposit accounts totaled \$798,000 for the quarter ended September 30, 2006, a decrease of \$57,000 or 6.7%, from \$855,000 in the third quarter of 2005. While deposits grew substantially over the past year, a significant amount of the growth was in higher balance accounts, including commercial accounts, which typically provide lower levels of fee income.

Mortgage banking activities include origination fees, service release premiums and the gain on the sales of mortgage loans held-for-sale. Mortgage banking activities totaled \$770,000, a decrease of \$120,000 or 13.5%, compared to \$890,000 in the third quarter of 2005. The decrease in mortgage banking activities income is primarily due to a lower level of originations. Originations of mortgage loans held-for-sale totaled \$38.7 million and \$48.0 million in the third quarter of 2006 and 2005, respectively.

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Payroll Solutions contributed \$673,000 to noninterest income for the quarter ended September 30, 2006, an increase of \$131,000 or 24.2%, compared to \$542,000 for the quarter ended September 30, 2005. The increase in fees is primarily due to new business started in the period, strong client retention and an increase in the number of employees on Payroll Solutions clients payrolls.

Losses on sales of other real estate owned totaled \$4,000 for the quarter ended September 30, 2006, an increase of \$340,000 or 101.2% compared to gains totaling \$336,000 in the third quarter of 2005.



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Other income increased \$137,000 or 39.7% to \$482,000 for the quarter ended September 30, 2006, compared to \$345,000 in the same quarter last year. The increase in other income is primarily attributable to servicing fees on SBA loans. In the quarter ended September 30, 2006, servicing fees on SBA loans totaled \$135,000. The SBA loan portfolio was acquired in the merger with First Capital.

**Noninterest expense** - Noninterest expense for the quarter ended September 30, 2006, totaled \$11.9 million, an increase of \$3.0 million or 34.1%, compared to \$8.9 million in the same quarter of 2005. Increases in salaries and benefits, occupancy expense, communications and postage, printing and supplies are primarily related to the increase in personnel and branches as a result of the merger with First Capital in the fourth quarter of 2005. Noninterest expense for the quarter ended September 30, 2006, included \$359,000 in merger-related charges. Merger-related charges were incurred in connection with the impending merger with RBC and were primarily for investment banking, legal and other professional charges. For more information on the merger between Flag and RBC see Note 2 to the Consolidated Financial Statements Mergers and Acquisitions.

Salaries and employee benefits for the quarter ended September 30, 2006, totaled \$7.3 million, an increase of \$1.8 million or 32.2%, from \$5.5 million in the third quarter of 2005. As a result of the merger with First Capital, increases in salaries and employee benefits are primarily related to additional personnel in the metro Atlanta area.

Occupancy expense for the quarter ended September 30, 2006, totaled \$1.2 million, an increase of \$179,000 or 18.3% from \$977,000 in the third quarter of 2005. Increases in rent expense are related to the addition of the First Capital branches and loan production offices.

Professional fees were \$110,000 for the quarter ended September 30, 2006, a decrease of \$319,000 or 74.4%, compared to \$429,000 in the same quarter of 2005. The decrease for the quarter ended September 30, 2006, is in part due to a decline in the amount of expenses related to continued compliance with the Sarbanes-Oxley Act and a decrease in legal fees. For the quarter ended September 30, 2006, professional fees related to the impending merger with RBC totaled \$339,000 and are included in merger-related charges.

Postage, printing and supplies costs for the quarter ended September 30, 2006 totaled \$505,000, an increase of \$248,000 or 96.5%, compared to \$257,000 in the third quarter of 2005. The increase in new customer accounts added through the First Capital acquisition contributed to the increase in postage, printing and supplies.

Communication and equipment costs for the quarter ended September 30, 2006 were \$678,000, an increase of \$139,000 or 25.8%, from \$539,000 in the third quarter of 2005. The increase is primarily a result of the additional offices acquired through the merger with First Capital.

Other noninterest expense totaled \$1.7 million for the quarter ended September 30, 2006, an increase of \$626,000 million or 56.2%, compared to \$1.1 million in the same quarter of 2005. Increases in other noninterest expense are a result of the growth of the Company primarily through the merger with First Capital. Marketing expense totaled \$341,000, an increase of \$91,000 or 36.2%, from \$250,000 in the third quarter of 2005. Marketing expense increased primarily due to increased marketing efforts in the metro Atlanta area. Other outside service fees increased in the quarter ended September 30, 2006, to \$277,000, an increase of \$122,000 or 78.7%, from \$155,000 in the third quarter of 2005. Outside service fees include both increases in service charges paid to the Federal Reserve and safekeeping fees paid on investments. These increases are related to higher levels of transactions processed by the Federal Reserve and an increase in investments resulting from the merger with First Capital. The addition of the First Capital branches and loan production offices also added to the increase in other outside service fees generated in the quarter ended September 30, 2006. Due to higher balances of amortizable intangible assets, related to the merger with First Capital, amortization expense increased \$66,000 or 87.2% to \$142,000 in the quarter ended September 30, 2006 compared to \$76,000 in the same quarter of 2005. In the quarter ended September 30, 2006, travel and entertainment increased \$98,000 or 72.9%, to \$233,000 compared to \$135,000 in the same quarter of 2005. The increase is primarily due to Flag's focus on growing its presence in the metro Atlanta market.

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**Income taxes** Income tax expense for the quarter ended September 30, 2006, totaled \$2.8 million compared to \$1.3 million for the same quarter of 2005. Flag's effective tax rate increased to 36.6% in the quarter ended September 30, 2006, compared to 32.7% in the same quarter of 2005. Flag's increase in the effective tax rate is due to the higher level of earnings and lower relative levels of tax exempt income.

**Results of Operations for the Nine Month Periods Ended September 30, 2006 and 2005**

**Net income** - Net income for the nine months ended September 30, 2006 totaled \$16.0 million, an increase of 135.9% as compared to \$6.8 million in the same period in 2005. Diluted earnings per share were \$0.90 for the nine months ended September 30, 2006, a 23.3% increase compared to \$0.73 in the same period of 2005. Net income includes pre-tax merger-related charges. For the nine months ended September 30, 2006, merger-related charges were \$359,000. Merger-related charges were incurred in connection with the impending merger with RBC and were primarily for investment banking, legal and other professional charges. For more information on the merger between Flag and RBC see Note 2 to the Consolidated Financial Statements - Mergers and Acquisitions.

**Net interest income** Net interest income for the nine months ended September 30, 2006, was \$50.5 million, an increase of \$22.6 million or 80.7% from \$27.9 million for the first nine months of 2005. Flag's net interest margin (net interest income on a taxable-equivalent basis divided by average interest-earning assets) decreased 39 basis points to 4.32% from 4.71% on average interest-earning assets of \$1.57 billion and \$800.4 million for the nine months ended September 30, 2006 and 2005, respectively. The net interest margin decreased in the nine months ended September 30, 2006, compared to the same period in 2005, primarily due to the inclusion of First Capital's lower yielding loan portfolio and tighter spreads resulting from the continued flattening/inversion of the yield curve. While both short-term and long-term interest rates have risen for the last year, the yield curve has flattened considerably with short-term rates rising more rapidly. The Federal Reserve has increased the discount rate six times since September 30, 2005, increasing the rate from 3.75% to 5.25% over the past twelve months. The Federal Reserve did not increase the discount rate during the quarter ended September 30, 2006, causing a greater downward pressure on the Company's net interest margin as the increase in the cost of interest-bearing liabilities exceeded the increase in the yield on interest-earning assets. The impact is evident in the decline in the net interest margin of 29 basis points during the third quarter ended September 30, 2006 compared to the second quarter of 2006. The Company continues to focus on core deposit growth as a lower cost funding source. For the nine months ended September 30, 2006, the cost of core deposits increased 46 basis points compared to the increase in the cost of short-terming borrowings of 303 basis points. For more information on Flag's asset and liability management program see Management's Discussion and Analysis of Financial Condition and Results of Operation - Market Risk Sensitivity.

**Interest income** - Interest income for the nine months ended September 30, 2006, was \$90.6 million, an increase of \$47.8 million or 111.7% compared to \$42.8 million in the same period in 2005. The increase is primarily due to higher levels of average interest-earning assets. Increases in average interest-earning assets are a result of the merger with First Capital and continued strong internal growth. An increase in the yield on interest-earning assets also contributed to the improvement in interest income. The taxable equivalent yield on interest-earning assets increased 53 basis points to 7.72% in the nine months ended September 30, 2006, compared to 7.19% in the same period of 2005.

Interest income and fees on loans increased \$39.5 million or 103.7% to \$77.6 million for the nine months ended September 30, 2006, compared to \$38.1 million in the same period last year. Average loans outstanding, including mortgage loans held-for-sale, during the nine months ended September 30, 2006, were \$1.25 billion compared to \$640.8 million for the first nine months of 2005. The yield on loans in the nine months ended September 30, 2006, was 8.29% an increase of 31 basis points from 7.98% in the same period last year. The increase in yield is primarily attributable to re-pricing of the adjustable rate loan portfolio as a result of the rising rate environment. Increases in interest rates during the 12 month period ended September 30, 2006, were largely offset by the inclusion of the First Capital lower yielding loan portfolio.

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Interest income on investment securities increased \$8.3 million or 221.8% to \$12.0 million for the nine months ended September 30, 2006, from \$3.7 million for the same period in 2005. The increase is the result of an increase in the average balance of investment securities coupled with an increase in the yield. The average balance of investment securities increased to \$293.2 million in the nine months ended September 30, 2006, from \$116.6 million in the first nine months of 2005. The yield on investment securities increased 111 basis points to 5.55% in the nine months ended September 30, 2006, from 4.44% in the same period in 2005. During the nine months ended September 30, 2006, \$27.9 million in investment securities repaid and Flag purchased \$93.2 million in investment securities with a higher average yield. In addition, in the fourth quarter of 2005, Flag initiated a repositioning of its balance sheet designed to further reduce its exposure to an anticipated continued increase in interest rates and to improve net interest margin and net interest income levels. Flag sold \$67.6 million in fixed-rate investments and reinvested the proceeds in a combination of fixed-rate and variable rate investments with a higher average yield.

Interest on federal funds sold and other interest-bearing deposits in banks increased \$48,000 or 5.1% in the nine months ended September 30, 2006, to \$993,000 from \$945,000 in the first nine months of 2005. The average balance of federal funds sold and other interest-bearing deposits decreased to \$27.0 million in the nine months ended September 30, 2006, from \$42.9 million in the first nine months of 2005. The yield on federal funds sold and other interest-bearing deposits increased 198 basis points to 4.92% from 2.94% during the nine months ended September 30, 2006, compared to 2005. Interest on federal funds sold and other interest-bearing deposits in banks increased as a result of the impact of the rise in the discount rate over the past 12 months.

**Interest expense** Interest expense for the nine months ended September 30, 2006, was \$40.1 million, an increase of \$25.3 million or 170.2% from \$14.8 million in the same period in 2005. The increase is due to higher levels of average interest-bearing liabilities coupled with a rising interest rate environment. Increases in average interest-bearing liabilities are a result of the merger with First Capital and continued strong internal growth. In the nine months ended September 30, 2006, average interest-bearing liabilities increased \$643.4 million or 94.9% to \$1.32 billion from \$723.6 million in the first nine months of 2005. Flag's total cost of interest-bearing liabilities increased 132 basis points to 4.06% from 2.74% over the same period last year, compared to a 150 basis point increase in the discount rate from September 30, 2005 to September 30, 2006. The increase reflects the impact of higher rates on variable rate borrowings and increases in deposit pricing.

Interest expense on deposits increased \$19.1 million or 142.2% to \$32.5 million in the nine months ended September 30, 2006, from \$13.4 million in the same period in 2005. The increase is due to both an increase in the average balance and cost of interest-bearing deposits. Average core deposits (noninterest-bearing, demand, money market and savings) in the nine months ended September 30, 2006, were \$775.4 million, an increase of \$360.7 million or 87.0%, from \$414.7 million in the first nine months of 2005. Core deposits offer the Bank a lower cost source of funds. The cost of core deposits increased 46 basis points to 2.41% in the nine months ended September 30, 2006 compared to 1.95% in the same period last year. Average noninterest-bearing demand deposits increased \$149.7 million or 271.4%, to \$204.8 million in the nine months ended September 30, 2006 compared to \$55.1 million in the same period last year. This significant increase in noninterest-bearing deposits was consistent with Flag's strategic intent to increase core deposits as a lower cost source of funding. Average time deposits in the nine months ended September 30, 2006, were \$560.8 million, an increase of \$242.5 million or 76.2% from \$318.3 million in the nine months ended September 30, 2005. The cost of time deposits increased 132 basis points to 4.42% in the nine months ended September 30, 2006 compared to 3.10% in the same period in 2005. The increase in the cost of deposits is primarily attributable to increased pricing of Flag's deposit products as a result of the rising rate environment.

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Interest expense on FHLB advances and other borrowings for the nine months ended September 30, 2006, was \$4.8 million, an increase of \$4.1 million or 648.0%, from \$639,000 for the same period of 2005. Average FHLB advances and other borrowings in the nine months ended September 30, 2006, were \$135.8 million, an increase of \$109.0 million or 406.6%, from \$26.8 million in the same period in 2005. The increase in average FHLB advances is a result of the merger with First Capital. The cost on FHLB advances and other borrowings increased 152 basis points to 4.71% in the nine months ended September 30, 2006 from 3.19% in the same period of 2005. The increase in the cost of FHLB advances and other borrowings reflects the impact of the rising rate environment on the adjustable rate advances.

Interest expense on federal funds purchased and repurchase agreements for the nine months ended September 30, 2006, was \$263,000, an increase of \$233,000 or 776.7%, from \$30,000 for the same period of 2005. The increase is attributable to higher short-term borrowings and an increase in the cost of short-term borrowings as a result of the rising rate environment. Average federal funds purchased and repurchase agreements in the nine months ended September 30, 2006, were \$7.3 million, an increase of \$5.1 million or 228.3%, from \$2.2 million in the same period in 2005. The cost of these borrowings increased 303 basis points to 4.84% in the nine months ended September 30, 2006 from 1.81% in the same period of 2005.

Interest expense on junior subordinated debt was \$2.5 million for the nine months ended September 30, 2006, an increase of \$1.8 million or 241.6% from \$743,000 for the same period of 2005. Average junior subordinated debentures increased \$30.0 million or 178.9%, to \$46.8 million in the nine months ended September 30, 2006 compared to \$16.8 million in the same period of 2005. In 2005, the Company issued \$25.8 million in junior subordinated debt to finance the merger with First Capital and for other general operating expenses. In addition, through its acquisition of First Capital in the fourth quarter of 2005, the Company recorded \$6.6 million in junior subordinated debt. The cost of junior subordinated debentures increased 133 basis points to 7.25% in the nine months ended September 30, 2006, compared to 5.92% in the same period of 2005. The increase in the cost of junior subordinated debentures is attributable to the rising rate environment and the related effect on the variable rate coupons.

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The following tables reflect the average balances, the interest income or expense and the average yield and cost of the Company's interest-earning assets and interest-bearing liabilities during the nine month periods presented (in thousands):

**Consolidated Average Balance Sheets**

|   | Nine Months Ended September 30, |                              |                       |                   |                              |                       |
|---|---------------------------------|------------------------------|-----------------------|-------------------|------------------------------|-----------------------|
|   | Average Balance                 | 2006 Interest Income/Expense | Weighted Average Rate | Average Balance   | 2005 Interest Income/Expense | Weighted Average Rate |
| <b>Assets:</b>                                    |                                 |                              |                       |                   |                              |                       |
| Loans <sup>(1)</sup>                              | \$ 1,253,705                    | \$ 77,759                    | 8.29%                 | \$ 640,793        | \$ 38,247                    | 7.98%                 |
| Taxable investment securities                     | 283,705                         | 11,634                       | 5.48%                 | 109,530           | 3,473                        | 4.24%                 |
| Tax-exempt investment securities <sup>(1)</sup>   | 9,447                           | 541                          | 7.66%                 | 7,092             | 399                          | 7.51%                 |
| Other interest-bearing deposits in banks          | 6,678                           | 229                          | 4.58%                 | 18,718            | 426                          | 3.04%                 |
| Federal funds sold                                | 20,309                          | 764                          | 5.03%                 | 24,221            | 519                          | 2.86%                 |
| <b>Total interest-earning assets</b>              | <b>1,573,844</b>                | <b>\$ 90,927</b>             | <b>7.72%</b>          | <b>800,354</b>    | <b>\$ 43,064</b>             | <b>7.19%</b>          |
| Noninterest-earning assets                        | 183,454                         |                              |                       | 57,122            |                              |                       |
| <b>Total assets</b>                               | <b>\$ 1,757,298</b>             |                              |                       | <b>\$ 857,476</b> |                              |                       |
| <b>Liabilities and stockholders' equity:</b>      |                                 |                              |                       |                   |                              |                       |
| Interest-bearing demand deposits                  | \$ 103,215                      | \$ 834                       | 1.08%                 | \$ 84,543         | \$ 682                       | 1.08%                 |
| Money market                                      | 447,476                         | 13,034                       | 3.89%                 | 253,456           | 5,281                        | 2.79%                 |
| Savings deposits                                  | 19,916                          | 100                          | 0.67%                 | 21,548            | 98                           | 0.61%                 |
| Time deposits                                     | 560,795                         | 18,557                       | 4.42%                 | 318,300           | 7,369                        | 3.10%                 |
| <b>Total interest-bearing deposits</b>            | <b>1,131,402</b>                | <b>32,525</b>                | <b>3.84%</b>          | <b>677,847</b>    | <b>13,430</b>                | <b>2.65%</b>          |
| FHLB advances and other borrowings                | 135,805                         | 4,780                        | 4.71%                 | 26,807            | 639                          | 3.19%                 |
| Federal funds purchased and repurchase agreements | 7,262                           | 263                          | 4.84%                 | 2,212             | 30                           | 1.81%                 |
| Junior subordinated debentures                    | 46,788                          | 2,538                        | 7.25%                 | 16,774            | 743                          | 5.92%                 |
| <b>Total interest-bearing liabilities</b>         | <b>1,321,257</b>                | <b>\$ 40,106</b>             | <b>4.06%</b>          | <b>723,640</b>    | <b>\$ 14,842</b>             | <b>2.74%</b>          |
| Noninterest-bearing demand deposits               | 204,799                         |                              |                       | 55,142            |                              |                       |
| Noninterest-bearing liabilities                   | 19,630                          |                              |                       | 7,428             |                              |                       |
| Stockholders' equity                              | 211,612                         |                              |                       | 71,266            |                              |                       |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 1,757,298</b>             |                              |                       | <b>\$ 857,476</b> |                              |                       |
| Net interest rate spread                          |                                 | \$ 50,821                    | 3.66%                 |                   | \$ 28,222                    | 4.45%                 |
| Taxable-equivalent adjustment                     |                                 | 335                          |                       |                   | 280                          |                       |
| Net interest income, actual                       |                                 | \$ 50,486                    |                       |                   | \$ 27,942                    |                       |

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|   |            |         |           |         |
|---|------------|---------|-----------|---------|
| Net interest-earning assets/net interest margin                         | \$ 252,587 | 4.32%   | \$ 76,714 | 4.71%   |
| Interest-earning assets as a percentage of interest-bearing liabilities |            | 119.12% |           | 110.60% |

(1) Tax equivalent basis.

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The following table shows the change in net interest income for the nine month periods presented due to changes in volumes and rates (in thousands):

**Rate/Volume Variance Analysis Taxable Equivalent Basis**

|   | Nine months ended September 30, |                   |                  |
|---|---------------------------------|-------------------|------------------|
|   | 2006 Compared to 2005           |                   |                  |
|   | Volume                          | Rate/<br>Yield    | Net<br>Change    |
| <b>Interest income:</b>                           |                                 |                   |                  |
| Loans   | \$ 38,015                       | \$ 1,497          | \$ 39,512        |
| Taxable investment securities                     | 7,142                           | 1,019             | 8,161            |
| Tax-free investment securities                    | 135                             | 7                 | 142              |
| Interest-bearing deposits in banks                | (413)                           | 2,216             | (197)            |
| Federal funds sold                                | (147)                           | 392               | 245              |
| <b>Total interest income</b>                      | <b>44,732</b>                   | <b>3,131</b>      | <b>47,863</b>    |
| <b>Interest expense:</b>                          |                                 |                   |                  |
| Interest-bearing demand deposits                  | 151                             | 1                 | 152              |
| Money market                                      | 5,651                           | 2,102             | 7,753            |
| Savings deposits                                  | (8)                             | 10                | 2                |
| Time deposits                                     | 8,024                           | 3,164             | 11,188           |
| FHLB advances and other borrowings                | 3,837                           | 304               | 4,141            |
| Federal funds purchased and repurchase agreements | 183                             | 50                | 233              |
| Junior subordinated debentures                    | 1,628                           | 167               | 1,795            |
| <b>Total interest expense</b>                     | <b>19,466</b>                   | <b>5,798</b>      | <b>25,264</b>    |
| <b>Net interest income</b>                        | <b>\$ 25,266</b>                | <b>\$ (2,667)</b> | <b>\$ 22,599</b> |

The increase in volume is due to the merger with First Capital and internal growth. The decrease in the rate/yield is primarily due to the influence of First Capital lower yielding loan portfolio coupled with the effects of a flat to inverted yield curve during 2006.

**Noninterest income** Noninterest income for the nine months ended September 30, 2006, increased \$930,000 million or 11.3% to \$9.2 million from \$8.2 million in the first nine months of 2005. Traditionally service charges on deposit accounts and revenues from mortgage banking activities have been the largest components of noninterest income.

Service charges on deposit accounts decreased to \$2.3 million for the nine months ended September 30, 2006, a decrease of \$113,000 or 4.7%, from \$2.4 million in the first nine months of 2005. While deposits grew substantially over the past year, a significant amount of the growth was in higher balance accounts, including commercial accounts, which typically provide lower levels of fee income.

Mortgage banking activities include origination fees, service release premiums and the gain on the sales of mortgage loans held-for-sale. Mortgage banking activities totaled \$2.5 million, an increase of \$311,000 or 14.4%, compared to \$2.2 million in the first nine months of 2005. The increase in mortgage banking activities income is primarily due to a higher level of originations and gains on sales of mortgage loans held-for-sale. Originations of mortgage loans held-for-sale totaled \$115.4 million and \$111.7 million for the nine months ended September 30,

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2006 and 2005, respectively. Gains recognized on the sales of mortgage loans increased to \$1.5 million for the nine months ended September 30, 2006 compared to \$1.2 million in the same period in 2005.

Payroll Solutions contributed \$2.1 million to noninterest income for the nine months ended September 30, 2006, an increase of \$467,000 or 28.8%, compared to \$1.6 million for the nine months ended September 30, 2005. The increase in fees is primarily due to new business started in the period, strong client retention and an increase in the number of employees on Payroll Solutions clients payrolls.



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**Flag Financial Corporation and Subsidiary**

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

For the nine months ended September 30, 2006, gains on the sales of other real estate owned totaled \$135,000 compared to \$558,000 in the same period last year. For the nine months ended September 30, 2006, there were no gains or losses on sales of securities, compared to gains totaling \$129,000 in the same period last year.

Other noninterest income increased \$740,000 or 65.1% to \$1.9 million in the nine months ended September 30, 2006, compared to \$1.1 million in the same period last year. In the nine months ended September 30, 2006, servicing fees on SBA loans totaled \$439,000. Servicing fees on SBA loans were generated by the SBA loan portfolio acquired in the merger with First Capital. Included in other noninterest income are gains and losses on the sales of fixed assets. In the first quarter of 2006, Flag sold its office in Columbus, Georgia and recognized a pre-tax gain on the sale totaling \$219,000. For the nine months ended September 30, 2006, total gains on the sales of fixed assets were \$223,000 compared to gains recognized of \$23,000 in the same period of 2005.

**Noninterest expense** - Noninterest expense for the nine months ended September 30, 2006, totaled \$34.1 million, an increase of \$8.7 million or 34.4%, compared to \$25.4 million in the same period of 2005. Increases in salaries and benefits, occupancy expense, communications and postage, printing and supplies are primarily related to the increase in personnel and branches as a result of the merger with First Capital in the fourth quarter of 2005. Noninterest expense for the nine months ended September 30, 2006, included \$359,000 in merger-related charges. Merger-related charges were incurred in connection with the impending merger with RBC and were primarily for investment banking, legal and other professional charges. For more information on the merger between Flag and RBC see Note 2 to the Consolidated Financial Statements Mergers and Acquisitions.

Salaries and employee benefits for the nine months ended September 30, 2006, totaled \$20.8 million, an increase of \$5.0 million or 31.8%, from \$15.8 million in the first nine months of 2005. As a result of the merger with First Capital, increases in salaries and employees benefits are primarily related to additional personnel in the metro Atlanta area.

Occupancy expense for the nine months ended September 30, 2006, totaled \$3.6 million, an increase of \$644,000 or 22.1% from \$2.9 million in the first nine months of 2005. Increases in rent expense are related to the addition of the First Capital branches and loan production offices.

Professional fees were \$844,000 million for the nine months ended September 30, 2006, a decrease of \$618,000 or 42.3%, compared to \$1.5 million in the same period of 2005. The decrease in the nine months ended September 30, 2006, is in part due to a decline in the amount of expenses related to continued compliance with the Sarbanes-Oxley Act and a decrease in legal fees. Additionally, for the nine months ended September 30, 2006, professional fees related to the impending merger with RBC totaled \$339,000 and are included in merger-related charges.

Postage, printing and supplies costs for the nine months ended September 30, 2006, totaled \$1.4 million, an increase of \$646,000 or 88.0%, compared to \$734,000 in the same period of 2005. The increase in new customer accounts added through the First Capital acquisition contributed to the increase in postage, printing and supplies.

Communication and equipment costs for the nine months ended September 30, 2006, were \$2.2 million, an increase of \$527,000 or 32.0%, from \$1.6 million in the same period of 2005. The increase is primarily a result of the additional offices acquired through the merger with First Capital.

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Other noninterest expense totaled \$5.0 million for the nine months ended September 30, 2006, an increase of \$2.1 million or 75.2%, compared to \$2.9 million in the same period of 2005. Increases in other noninterest expense are a result of the growth of the Company primarily through the merger with First Capital. Marketing expense totaled \$959,000, an increase of \$396,000 or 70.3%, from \$563,000 in the first nine months of 2005. Marketing expense increased primarily due to increased marketing efforts in the metro Atlanta area. Other outside service fees increased in the nine months ended September 30, 2006, to \$790,000, an increase of \$397,000 or 101.0%, from \$393,000 in the same period of 2005. Outside service fees include both increases in service charges paid to the Federal Reserve and safekeeping fees paid on investments. These increases are primarily related to higher levels of transactions processed by the Federal Reserve and an increase in investments resulting from the merger with First Capital. The addition of the First Capital branches and loan production offices also added to the increase in other outside service fees generated in the nine months ended September 30, 2006. Due to higher balances of amortizable intangible assets, related to the merger with First Capital, amortization expense increased to \$427,000, an increase of \$306,000 or 252.8% in the nine months ended September 30, 2006 compared to \$121,000 in the same period of 2005. In the nine months ended September 30, 2006, travel and entertainment increased \$400,000 or 112.3%, to \$757,000 compared to \$357,000 in the same period of 2005. The increase is primarily due to Flag's focus on growing its presence in the metro Atlanta market. Regulatory fees and FDIC insurance totaled \$252,000, an increase of \$82,000 or 48.4%, from \$170,000 in the first nine months of 2005. The increase in regulatory fees and FDIC insurance is a result of the Company's growth over the prior year.

**Income taxes** Income tax expense for the nine months ended September 30, 2006, totaled \$9.0 million compared to \$3.3 million for the same period of 2005. Flag's effective tax rate increased to 36.0% in the nine months ended September 30, 2006, compared to 32.5% in the same period of 2005. Flag's increase in the effective tax rate is due to the higher level of earnings and lower relative levels of tax exempt income.

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**Flag Financial Corporation and Subsidiary**

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

As of September 30, 2006, there were no substantial changes in the composition of Flag's market-sensitive assets and liabilities or their related market values from those reported as of December 31, 2005. The foregoing disclosures related to the market risk of Flag should be read in conjunction with Flag's audited consolidated financial statements, related notes and management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2005, included in Flag's 2005 Annual Report on Form 10-K.

**Item 4. Controls and Procedures**

As of the end of the period covered by this report, Flag carried out an evaluation, under the supervision and with the participation of Flag's management, including Flag's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Flag's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, Flag's Chief Executive Officer and Chief Financial Officer concluded that Flag's disclosure controls and procedures are effective in timely alerting them to material information relating to Flag (including its consolidated subsidiary) that is required to be included in Flag's periodic filings with the Securities and Exchange Commission. There have been no changes in Flag's internal controls or, to Flag's knowledge, in other factors during the quarter covered by this report that have materially affected, or are reasonable likely to materially affect, Flag's internal controls.

**Table of Contents****Part II. Other Information****Flag Financial Corporation and Subsidiary****Item 1. Legal Proceedings - None****Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition and/or operating results.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table sets forth information regarding the Company's purchases of its common stock on a monthly basis during the quarter ended September 30, 2006 (in thousands):

| Period                                 | Total Number of<br>Shares Purchased | Average Price<br>Paid Per Share | Total Number of<br>Shares Purchased as<br>Part Of Publicly<br>Announced Plans<br>Or Programs <sup>(1)</sup> | Maximum<br>Number Of Shares<br>that May Yet Be<br>Purchased Under the<br>Plans or Programs |
|--|-------------------------------------|---------------------------------|---|--|
| July 1 through July 31, 2006           |                                     |                                 | 1,551   | 549  |
| August 1 through August 31, 2006       |                                     |                                 | 1,551   | 549  |
| September 1 through September 30, 2006 |                                     |                                 | 1,551   | 549  |
| Total                                  |                                     |                                 | 1,551   | 549  |

<sup>(1)</sup> On March 19, 2004, Flag Financial Corporation announced a stock repurchase plan. The Company's Board of Directors authorized the repurchase of up to 10% of the Company's outstanding shares of common stock. No expiration date was specified, and no shares were repurchased under the plan during the quarter ended September 30, 2006. As of September 30, 2006, the Company has repurchased 304,000 shares at an aggregate cost of \$3.9 million.

**Item 3. Defaults upon Senior Securities - None****Item 4. Submission of Matters to a Vote of Security Holders - None****Item 5. Other Information - None****Item 6. Exhibits**

- 31.1 Section 302 Certification by Chief Executive Officer
- 31.2 Section 302 Certification by Chief Financial Officer
- 32.1 Section 906 Certification by Chief Executive Officer and Chief Financial Officer

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**SIGNATURES**

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

**Flag Financial Corporation**

/s/ Joseph W. Evans  
Joseph W. Evans  
Chief Executive Officer

November 8, 2006

/s/ J. Daniel Speight  
J. Daniel Speight  
Chief Financial Officer

November 8, 2006