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COOPERATIVE BANKSHARES INC
Form 10-Q
November 09, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

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: 0-24626

COOPERATIVE BANKSHARES, INC.

(Exact name of registrant as specified in its charter)

North Carolina

56-1886527

(State or other jurisdiction of incorporation
or organization)

(I.R.S. Employer
Identification No.)

201 Market Street, Wilmington, North Carolina

28401

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (910) 343-0181

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

N/A

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

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Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS: Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 4,303,816 shares at November 3, 2005

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	SEPTEMBER 30, 2005
	(UNAUDITED)
ASSETS	
Cash and due from banks, noninterest-bearing	\$ 19,489,210
Interest-bearing deposits in other banks	

Total cash and cash equivalents	19,489,210
Securities:	
Available for sale (amortized cost of \$43,123,458 in September 2005 and \$44,432,476 in December 2004)	42,575,710
Held to maturity (estimated market value of \$2,140,085 in September 2005 and \$2,678,860 in December 2004)	2,175,070
FHLB stock	5,423,900
Loans held for sale	7,240,820
Loans	615,853,960
Less allowance for loan losses	5,844,100

Net loans	610,009,860
Other real estate owned	26,290
Accrued interest receivable	2,916,680
Premises and equipment, net	9,937,440
Goodwill	1,461,540
Other assets	14,324,460

Total assets	\$ 715,581,010
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Deposits	\$ 542,009,270
Short-term borrowings	25,419,470
Escrow deposits	396,840
Accrued interest payable	444,700
Accrued expenses and other liabilities	3,838,630
Long-term obligations	93,542,660

Total liabilities	665,651,590

Stockholders' equity:	
Preferred stock, \$1 par value, 3,000,000 shares authorized,	

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no shares issued and outstanding	
Common stock, \$1 par value, 14,000,000 shares authorized, 4,302,816 and 2,860,764 shares issued and outstanding	4,302,816
Additional paid-in capital	2,711,599
Accumulated other comprehensive income (loss)	(361,511)
Retained earnings	43,276,522
Total stockholders' equity	49,929,426
Total liabilities and stockholders' equity	\$ 715,581,011
Book value per common share**	\$ 11.6

* Derived from audited consolidated financial statements.

** The 2004 information is computed after giving the retroactive effect of a 3-for-2 stock split a 50% stock dividend declared on January 19, 2005 and paid on February 24, 2005.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,	
	2005	2004
INTEREST INCOME:		
Loans	\$ 9,907,182	\$ 6,409,154
Securities	524,467	557,179
Other	27,333	12,356
Dividends on FHLB stock	46,241	37,653
Total interest income	10,505,223	7,016,342
INTEREST EXPENSE:		
Deposits	3,306,204	1,635,174
Borrowed funds	1,158,380	713,094
Total interest expense	4,464,584	2,348,268
NET INTEREST INCOME	6,040,639	4,668,074
Provision for loan losses	575,000	225,000
Net interest income after provision for loan losses	5,465,639	4,443,074
NONINTEREST INCOME:		
Gain on sale of loans	570,694	682,115
Service charges and fees on loans	248,513	159,359

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Deposit-related fees	494,672	418,910
Bank-owned life insurance earnings	95,283	73,182
Other income, net	48,813	61,750
	-----	-----
Total noninterest income	1,457,975	1,395,316
	-----	-----
NONINTEREST EXPENSES:		
Compensation and fringe benefits	2,656,391	2,349,614
Occupancy and equipment	911,423	834,037
Professional and examination fees	118,623	87,276
Advertising	160,242	140,476
Other	516,777	503,713
	-----	-----
Total noninterest expenses	4,363,456	3,915,116
	-----	-----
Income before income taxes	2,560,158	1,923,274
Income tax expense	1,054,288	636,845
	-----	-----
NET INCOME	\$ 1,505,870	\$ 1,286,429
	=====	=====
NET INCOME PER SHARE:		
Basic*	\$ 0.35	\$ 0.30
	=====	=====
Diluted*	\$ 0.34	\$ 0.30
	=====	=====
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic*	4,301,553	4,291,146
	=====	=====
Diluted*	4,379,214	4,360,517
	=====	=====

* The 2004 information is computed after giving the retroactive effect of a 3-for-2 stock split in 2004 and a 50% stock dividend declared on January 19, 2005 and paid on February 24, 2005.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)

COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)
-----	-----	-----

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Balance, December 31, 2004	\$ 2,860,764	\$ 2,673,233	\$ 67,672	\$
Exercise of stock options	16,223	101,538	--	
Stock traded to exercise options (4,522 shares)	(4,522)	(80,944)	--	
Tax benefit of stock option exercised	--	17,766	--	
3-for-2 stock split in the form of a 50% dividend	1,430,351	--	--	
Other comprehensive loss, net of taxes	--	--	(429,183)	
Net income	--	--	--	
Cash dividends (\$.15 per share)	--	--	--	
	-----	-----	-----	-----
Balance, September 30, 2005	\$ 4,302,816	\$ 2,711,593	\$ (361,511)	\$
	=====	=====	=====	=====

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	NINE MONTHS SEPT 2005

OPERATING ACTIVITIES:	
Net income	\$ 4,044,419
Adjustments to reconcile net income to net cash used in operating activities:	
Net accretion, amortization, and depreciation	740,902
Gain on sale of loans	(1,895,323)
Deferred income taxes	(466,664)
Loss on sale of premises and equipment	7,534
Gain on sale of other real estate owned	-
Valuation losses on other real estate owned	12,886
Provision for loan losses	1,550,000
Proceeds from sale of loans	120,055,296
Loan originations held for sale	(118,162,339)
Changes in assets and liabilities:	
Accrued interest receivable	(831,522)
Other assets	29,690
Accrued interest payable	254,012
Accrued expenses and other liabilities	1,227,212

Net cash provided in operating activities	6,566,103

INVESTING ACTIVITIES:	
Purchases of securities available for sale	-
Purchase of Lumina Mortgage Company	-
Proceeds from maturity of securities available for sale	-

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Repayments of mortgage-backed securities available for sale	1,308,718
Repayments of mortgage-backed securities held to maturity	484,871
Net sales (purchases) of FHLB stock	(905,400)
Loan originations, net of principal repayments	(162,189,538)
Proceeds from disposals of other real estate owned	14,870
Additions to other real estate owned	(7,196)
Purchases of premises and equipment	(2,093,911)
Investment in unconsolidated Trust	(464,000)
Proceeds from sale of premises and equipment	5,000

Net cash used in investing activities	(163,846,586)

FINANCING ACTIVITIES:	
Net increase in deposits	127,251,372
Net change in short-term borrowings	(11,923,408)
Net change in long-term obligations	45,459,992
Proceeds from issuance of common stock, net	32,295
Dividends	(645,574)
Net change in escrow deposits	202,438

Net cash provided (used) by financing activities	160,377,115

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,096,632
CASH AND CASH EQUIVALENTS:	
BEGINNING OF PERIOD	16,392,587

END OF PERIOD	\$ 19,489,219
	=====

(Continued)

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COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

	NINE MONTHS EN SEPTEMBER 30	
	2005	
	-----	-----
Cash paid for:		
Interest	\$ 10,691,132	\$
Income taxes	2,595,015	
Summary of noncash investing and financing activities:		
Transfer from loans to other real estate owned	46,851	
Loans to facilitate the sale of other real estate owned	-	
Unrealized loss on securities available for sale, net of taxes	(429,183)	
Reclassifications between long-term obligations		

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and short-term borrowings

5,000,000

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. **Accounting Policies:** The significant accounting policies followed by

Cooperative Bankshares, Inc. (the "Company") for interim financial reporting are consistent with the accounting policies followed for annual financial reporting. These unaudited consolidated financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X, and, in management's opinion, all adjustments of a normal recurring nature necessary for a fair presentation have been included. The accompanying consolidated financial statements do not purport to contain all the necessary financial disclosures that might otherwise be necessary in the circumstances and should be read in conjunction with the consolidated financial statements and notes thereto in the Company's Annual Report on form 10-K for the year ended December 31, 2004 (the "Annual Report"). The results of operations for the nine-month period ended September 30, 2005 are not necessarily indicative of the results to be expected for the full year.
2. **Basis of Presentation:** The accompanying unaudited consolidated financial

statements include the accounts of Cooperative Bankshares, Inc., Cooperative Bank (the "Bank") and its wholly owned subsidiaries, Lumina Mortgage Company, Inc. ("Lumina") and CS&L Holdings, Inc. ("Holdings"), and Holdings' majority owned subsidiary, CS&L Real Estate Trust, Inc. (the "REIT"). All significant intercompany items have been eliminated. The Company formed Cooperative Bankshares Capital Trust I (the "Trust") on August 30, 2005, which is wholly owned by the Company, to facilitate the issuance of trust preferred securities totaling \$15.0 million. The Trust is not consolidated in these financial statements due to the adoption of FASB Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities. The junior subordinated debentures issued by the Company to the Trust were included in long-term obligations and the Company's equity interest in the Trust was included in other assets. Certain items for prior periods have been reclassified to conform to the current period presentation. These reclassifications have no effect on the net income or stockholders' equity as previously reported.
3. **Junior Subordinated Debentures:** The Trust was formed with the sole purpose

of issuing the trust preferred securities and investing the proceeds from the sale of such trust preferred securities in the debentures. The debentures held by the Trust are the sole assets of the Trust. The Company owns 100% of the Trust's outstanding common securities and unconditionally guarantees the Trust's financial obligations. The debentures and the trust preferred securities bear an interest rate of 5.74% for the first five years, and thereafter bear an interest rate equal to 142 basis points over

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the three-month LIBOR (London Inter-Bank Offered Rate). The trust preferred securities generally rank equal to the trust common securities in priority of payment, but will rank prior to trust common securities if and so long as the Company fails to make principal or interest payment on the debentures. Concurrently with the issuance of the debentures and the trust preferred securities, the Company entered into a Guaranty Agreement, dated August 30, 2005, related to the trust preferred securities for the benefit of the holders. The debentures and trust preferred securities each have 30-year lives and will each be callable by the Company or the Trust, at their option, after five years. The Company has the option to defer interest for up to five years on the debentures. The debentures qualify as Tier I capital under Federal Reserve Board guidelines.

4. Earnings Per Share: Earnings per share ("EPS") is calculated by dividing

net income by the weighted average number of common shares outstanding ("basic EPS") and the sum of the weighted average number of common shares outstanding and potential common stock ("diluted EPS"). Potential common stock consists of stock options issued and outstanding. In determining the number of shares of potential common stock, the treasury stock method was applied. This method assumes that the number of shares issuable upon exercise of the stock options is reduced by the number of common shares assumed purchased at market prices with the proceeds from the assumed exercise of the common stock options plus any tax benefits received as a result of the assumed exercise. The following table provides a reconciliation of income available to common stockholders and the average number of shares outstanding for the periods below after giving the retroactive effect of a 3-for-2 stock split in the form of a 50% stock dividend declared on January 19, 2005 and paid on February 24, 2005:

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	THREE MONTHS ENDED SEPTEMBER 30,		NINE MO SEPT
	2005	2004	2005
Net income (numerator)	\$ 1,505,870	\$ 1,286,429	\$ 4,044,41
Shares for basic EPS (denominator)	4,301,553	4,291,146	4,296,67
Dilutive effect of stock options	77,661	69,371	78,47
Shares for diluted EPS (denominator)	4,379,214	4,360,517	4,375,15
	=====	=====	=====

For the periods ended September 30, 2005 and 2004, there were 0 and 4,000 options outstanding, respectively, that were not dilutive since the exercise price did not exceed the average market price. These options have been omitted from the calculation of the dilutive effect of stock options.

5. Comprehensive Income: Comprehensive income includes net income and all

other changes to the Company's equity, with the exception of transactions with shareholders ("other comprehensive income"). The Company's only components of other comprehensive income relate to unrealized gains and losses on available for sale securities. The following table sets forth the components of other comprehensive income and total comprehensive income for the three and nine months ended September 30.

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	THREE MONTHS ENDED SEPTEMBER 30,		NINE MON SEPT
	2005	2004	2005
Net income	\$ 1,505,870	\$ 1,286,429	\$ 4,044,41
Other comprehensive income			
Realized (gains) losses on available for sale securities	-	-	
Unrealized gains (losses) on available for sale securities	(537,853)	491,801	(650,27
Income taxes	182,870	(167,213)	221,09
Other comprehensive income (loss)	(354,983)	324,588	(429,18
Comprehensive income	\$ 1,150,887	\$ 1,611,017	\$ 3,615,23

6. Stock-Based Compensation: On January 1, 1996 the Company adopted SFAS

 No. 123, "Accounting for Stock-Based Compensation." As permitted by SFAS No. 123, the Company has chosen to continue to apply APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The option exercise price is the market price of the common stock on the date the option is granted. Accordingly, no compensation cost has been recognized for options granted under the Option Plan. Had compensation cost for the Company's Option Plan been determined based on the fair value at the grant dates for awards under the option plan consistent with the method of SFAS No. 123, the Company's net income and net income per share would have been reduced to the pro forma amounts indicated below.

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	THREE MONTHS ENDED SEPTEMBER 30,		NINE MON SEPT
	2005	2004	2005
Net income, as reported	\$ 1,505,870	\$ 1,286,429	\$ 4,044,419
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	-	-	-
Pro forma net income	\$ 1,505,870	\$ 1,286,429	\$ 4,044,419
Earnings per share:			
Basic-as reported	\$ 0.35	\$ 0.30	\$ 0.94
Basic-pro forma	\$ 0.35	\$ 0.30	\$ 0.94
Diluted-as reported	\$ 0.34	\$ 0.30	\$ 0.92
Diluted-pro forma	\$ 0.34	\$ 0.30	\$ 0.92

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7. Recent Accounting Pronouncements: In December 2004, the FASB issued SFAS No. 123(R), "Accounting for Stock-Based Compensation (SFAS No. 123(R))." SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires that the fair value of such equity instruments be recognized as an expense in the historical financial statements as services are performed. Prior to SFAS No. 123(R), only certain pro forma disclosures of fair value were required. This Statement was amended on April 14, 2005 to make the provisions of this Statement effective at the beginning of the next fiscal year that begins after June 15, 2005. Accordingly, we will adopt SFAS No. 123(R) on January 1, 2006. Since it is likely that we will grant additional stock options in the future, the adoption of SFAS No. 123(R) is expected to have a material effect on our consolidated financial statements.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

Cooperative Bankshares, Inc. (the "Company") is a registered bank holding company incorporated in North Carolina in 1994. The Company is the parent company of Cooperative Bank (the "Bank"), a North Carolina chartered commercial bank. The Bank, headquartered in Wilmington, North Carolina, was chartered in 1898. The Bank provides financial services through 20 offices in Eastern North Carolina. One of the Bank's subsidiaries, Lumina Mortgage Company, Inc. ("Lumina") is a mortgage banking firm originating and selling residential mortgage loans through 5 offices along the coast from North Myrtle Beach, South Carolina to Virginia Beach, Virginia, with an additional office in Charlotte, North Carolina. The Bank's other subsidiary, CS&L Holdings, Inc. ("Holdings") is a holding company incorporated in Virginia for CS&L Real Estate Trust, Inc. (the "REIT"), which is a real estate investment trust.

Through its offices, the Bank provides a wide range of banking products, including interest-bearing and noninterest-bearing checking accounts, certificates of deposit, savings accounts and individual retirement accounts. It offers an array of loan products: overdraft protection, commercial, consumer, agricultural, real estate, residential mortgage and home equity loans. Also offered are safe deposit boxes and automated banking services through ATMs and Access24 Phone Banking. The Bank also offers free Online Banking and Bill Pay for personal accounts. In addition, the Bank offers discount brokerage services, annuity sales and mutual funds through a third party arrangement with UVEST Investment Services.

The Bank opened its new Shipyard office on August 1, 2005, which was a relocation of its Wilmington Long Leaf branch. The Bank is scheduled to open another Wilmington branch at Porter's Neck on January 3, 2006. The Bank will close its Ogden office on December 30, 2005. The Bank began utilizing its new Operations and Training Center in May 2005. On August 10, 2005, Lumina opened a mortgage office in Charlotte, North Carolina. The Company formed Cooperative Bankshares Capital Trust I (the "Trust") on August 30, 2005, which is wholly

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owned by the Company, to facilitate the issuance of trust preferred securities totaling \$15.0 million. The Trust was formed with the sole purpose of issuing the trust preferred securities and investing the proceeds from the sale of such trust preferred securities in the debentures. The Company owns 100% of the Trust's outstanding common securities and unconditionally guarantees the Trust's financial obligations. The debentures held by the Trust are the sole assets of the Trust. The debentures and the trust preferred securities bear an interest rate of 5.74% for the first five years, and thereafter bear an interest rate equal to 142 basis points over the three-month LIBOR (London Inter-Bank Offered Rate). The trust preferred securities generally rank equal to the trust common securities in priority of payment, but will rank prior to trust common securities if and so long as the Company fails to make principal or interest payment on the debentures. Concurrently with the issuance of the debentures and the trust preferred securities, the Company entered into a Guaranty Agreement, dated August 30, 2005, related to the trust preferred securities for the benefit of the holders. The debentures and trust preferred securities each have 30-year lives and will each be callable by the Company or the Trust, at their option, after five years. The Company has the option to defer interest for up to five years on the debentures. The debentures qualify as Tier I capital under Federal Reserve Board guidelines. The Trust is not consolidated in these financial statements due to the adoption of FASB Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities. The junior subordinated debentures issued by the Company to the Trust were included in long-term obligations and the Company's equity interest in the Trust was included in other assets.

MISSION STATEMENT

It is the mission of the Company to provide the maximum in safety and security for our depositors, an equitable rate of return for our stockholders, excellent service for our customers, and to do so while operating in a fiscally sound and conservative manner, with fair pricing of our products and services, good working conditions, outstanding training and opportunities for our staff, along with a high level of corporate citizenship.

MANAGEMENT STRATEGY

The Bank's lending activities have traditionally concentrated on the origination of loans for the purpose of constructing, financing or refinancing residential properties. In recent years the Bank has emphasized the origination of nonresidential real estate loans and secured and unsecured consumer and business loans. As of September 30, 2005, approximately \$425 million, or 69%, of the Bank's loan portfolio, which excludes loans held for sale, consisted of loans secured by residential properties. This compares to approximately \$309 million, or 68% at December 31, 2004. The Bank originates adjustable rate and fixed rate loans. As of September 30, 2005, adjustable rate and fixed rate loans totaled approximately 64% and 36%, respectively, of the Bank's total loan portfolio.

The Bank has chosen to sell a large percentage of its fixed rate mortgage loan originations in the secondary market and through brokered arrangements. This enables the Bank to invest these funds in commercial loans, while increasing fee income and reducing interest rate risk.

INTEREST RATE SENSITIVITY ANALYSIS

Interest rate sensitivity refers to the change in interest spread resulting from changes in interest rates. To the extent that interest income and interest expense do not respond equally to changes in interest rates, or that all rates do not change uniformly, earnings will be affected. Interest rate sensitivity, at a point in time, can be analyzed using a static gap analysis that measures the match in balances subject to repricing between interest-earning assets and interest-bearing liabilities. Gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive

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liabilities. Gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. At September 30, 2005, the Company had a one-year positive gap position of 3.9% as compared to 8.8% at December 31, 2004. During a period of falling interest rates, a positive gap would tend to adversely affect net interest income, while a negative gap would tend to result in an increase in net interest income. During a period of rising interest rates, a positive gap would tend to result in an increase in net interest income while a negative gap would tend to adversely affect net interest income. It is important to note that certain shortcomings are inherent in static gap analysis. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. For example, a part of the Company's adjustable-rate mortgage loans are indexed to the National Monthly Median Cost of Funds to SAIF-insured institutions. This index is considered a lagging index that may lag behind changes in market rates. The one-year or less interest-bearing liabilities also include checking, savings and money market deposit accounts. Experience has shown that the Company sees relatively modest repricing on these types of transaction accounts. Management takes this into consideration in determining acceptable levels of interest rate risk.

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When Lumina gives a rate lock commitment to a customer, there is a concurrent "lock in" for the loan with a secondary market investor under a best efforts delivery mechanism. Therefore, interest rate risk is mitigated because any commitment to fund a loan available for sale is concurrently hedged by a commitment from an investor to purchase the loan under the same terms. Loans are usually sold within 60 days after closing.

LIQUIDITY

The Company's goal is to maintain adequate liquidity to meet potential funding needs of loan and deposit customers, pay operating expenses and meet regulatory liquidity requirements. Maturing securities, principal repayments of loans and securities, deposits, income from operations and borrowings are the main sources of liquidity. The Bank has been granted a line of credit by the Federal Home Loan Bank of Atlanta ("FHLB") in an amount of up to 25% of the Bank's total assets. At September 30, 2005, the Bank's borrowed funds from the FHLB equaled 13.6% of its total assets. Scheduled loan repayments are a relatively predictable source of funds, unlike deposits and loan prepayments that are significantly influenced by general interest rates, economic conditions and competition. Additionally, during the three-months ended September 30, 2005 the Bank issued brokered deposits of \$10.6 million and the Company issued \$15.5 million in junior subordinated debentures in a pooled trust preferred offering on August 30, 2005.

At September 30, 2005, the estimated market value of liquid assets (cash, cash equivalents, marketable securities and loans held for sale) was approximately \$71.4 million, which represents 10.8% of deposits and borrowed funds as compared to \$70.8 million or 14.2% of deposits and borrowed funds at December 31, 2004. The decrease in the liquidity percentage was due to increases in deposits and long-term obligations to fund the increase in loans.

The Company's primary uses of liquidity are to fund loans and to make investments. Management considers current liquidity levels adequate to meet the Company's cash flow requirements. If the loan portfolio continues to increase as it has in 2005, additional funding sources, such as brokered deposits, junior subordinated debentures or loan sales may need to be considered.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL COMMITMENTS

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At September 30, 2005, outstanding off-balance sheet commitments to extend credit totaled \$71.2 million, and the undisbursed portion of construction loans was \$81.0 million. The Bank continued to be obligated to make future payments under contracts, such as debt and lease agreements, the amounts of which were consistent with the amounts at December 31, 2004 other than the increase in borrowed funds of \$33.5 million and the increase in deposits of \$127.3 million at September 30, 2005. For further information see "Financial Condition at September 30, 2005 compared to December 31, 2004".

CAPITAL

Stockholders' equity at September 30, 2005, was \$49.9 million, up 6.4% from \$46.9 million at December 31, 2004. Stockholders' equity at September 30, 2005, includes an unrealized loss net of tax of \$362,000 as compared to an unrealized gain net of tax at December 31, 2004, of \$68,000 on securities available for sale marked to estimated fair market value.

Under the capital regulations of the FDIC, the Bank must satisfy minimum leverage ratio requirements and risk-based capital requirements. Banks supervised by the FDIC must maintain a minimum leverage ratio of core ("Tier I") capital to average adjusted assets ranging from 3% to 5%. At September 30, 2005, the Bank's ratio of Tier I capital was 8.66%. The FDIC's risk-based capital rules require banks supervised by the FDIC to maintain risk-based capital to risk-weighted assets of at least 8.00%. Risk-based capital for the Bank is defined as Tier I capital plus the balance of allowance for loan losses. At September 30, 2005, the Bank had a ratio of qualifying total capital to risk-weighted assets of 11.12%.

The Company, as a bank holding company, is also subject, on a consolidated basis, to the capital adequacy guidelines of the Board of Governors of the Federal Reserve (the "Federal Reserve Board"). The capital requirements of the Federal Reserve Board are similar to those of the FDIC governing the Bank. The Company currently exceeds all of its capital requirements. Management expects the Company to continue to exceed these capital requirements without altering current operations or strategies.

The Company's Board of Directors approved a quarterly cash dividend of \$.05 per share, paid on October 17, 2005 to stockholders of record as of October 1, 2005. Any future payment of dividends is dependent on the financial condition and capital needs of the Company, requirements of regulatory agencies and economic conditions in the marketplace.

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CRITICAL ACCOUNTING POLICIES

The Bank's most significant critical accounting policies are those that govern accounting for loans and its allowance for loan losses and goodwill. A critical accounting policy is one that is both very important to the portrayal of the Company's financial condition and results, and requires a difficult, subjective or complex judgment by management. What makes these judgments difficult, subjective and/or complex is the need to make estimates about the effects of matters that are inherently uncertain. For further information on the allowance for loan losses, see the "Critical Accounting Policies" and the "Financial Condition" in Management's Discussion and Analysis and Note 3 of "Notes to Consolidated Financial Statements" included in the Annual Report on Form 10-K filed with the SEC on March 30, 2005. For further information on goodwill, see the "Critical Accounting Policies" in Management's Discussion and Analysis and

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Note 13 of "Notes to Consolidated Financial Statements" included in the Annual Report on Form 10-K filed with the SEC on March 30, 2005.

FINANCIAL CONDITION AT SEPTEMBER 30, 2005 COMPARED TO DECEMBER 31, 2004

The Company's total assets increased 30.1% to \$715.6 million at September 30, 2005, as compared to \$550.1 million at December 31, 2004. The primary causes of the increase in assets were increases of \$162.1 million (35.7%) in loans, and \$3.1 million (18.9%) in cash and cash equivalents which were funded primarily by an increase in deposits of \$127.3 million (30.7%) and long-term obligations of \$40.5 million (76.2%). The increase in loans and deposits was a result of continued growth in newer branches and being located in vibrant markets. The majority of the loan growth occurred in construction and land development loans which grew \$86.6 million (135.4%) and commercial real estate loans which grew \$39.9 million (36.7%) over the nine-month period ending September 30, 2005, due to the economic expansion in the Bank's market area and the Bank's increased emphasis on commercial lending. The largest increase in deposits was in the thirteen and twenty-two month certificates and checking accounts. The increase in the certificates was due to the Bank offering competitive promotional rates on reasonably short term deposits in an effort to foster deposit growth. The Bank continues to emphasize obtaining business accounts, which is the reason for the checking account increase. The Bank also attracted an additional \$24.7 million in internet deposits during the nine-month period ending September 30, 2005. Internet deposits are usually obtained from other financial institutions with terms primarily of one to two years. In addition, the bank accepted brokered deposits for the first time in the amount of \$10.6 million. Borrowed funds which are collateralized through an agreement with the FHLB for advances increased \$18.0 million since December 31, 2004. These advances are secured by the Bank's investment in FHLB stock and qualifying first mortgage loans. Loans made at Lumina are held for sale and are funded by a short-term borrowing at another financial institution, which decreased \$249,000 since December 31, 2004, and are collateralized by Lumina's loans held for sale. The Company also issued \$15.5 million in junior subordinated debentures on August 30, 2005.

The Company's nonperforming assets (loans 90 days or more delinquent and foreclosed real estate) were \$345,000 or 0.05% of assets, at September 30, 2005, compared to \$207,000, or 0.04% of assets, at December 31, 2004. Foreclosed real estate increased to \$26,000 at September 30, 2005, from \$0 at December 31, 2004. The Company assumes an aggressive position in collecting delinquent loans and disposing of foreclosed assets to minimize balances of nonperforming assets and continues to evaluate the loan and real estate portfolios to provide loss reserves as considered necessary. For further information see "Comparison of Operating Results - Provision and Allowance for Loan Losses."

COMPARISON OF OPERATING RESULTS

OVERVIEW

The net income of the Company depends primarily upon net interest income. Net interest income is the difference between the interest earned on loans, the securities portfolio and interest-earning deposits and the cost of funds, consisting principally of the interest paid on deposits and borrowings. The Company's operations are materially affected by general economic conditions, the monetary and fiscal policies of the Federal government, and the policies of regulatory authorities. Yields and costs have increased because of the actions taken by the Federal Reserve over the past several months to increase interest rates.

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NET INCOME

Net income for the three and nine-month periods ended September 30, 2005, increased 17.1% to \$1.5 million and 21.5% to \$4.0 million respectively, as compared to the same periods last year. The increase in net income for the three and nine-month periods ended September 30, 2005 can be attributed to an increase in net interest income of \$1.4 million and \$3.1 million respectively, as well as an increase in noninterest income of \$63,000 and \$344,000 respectively. For further information see the captions "Noninterest Income" and "Noninterest Expense."

INTEREST INCOME

For the three-month period ended September 30, 2005, interest income increased 49.7% as compared to the same period a year ago. The average balance of interest-earning assets increased 29.6% and the average yield increased 86 basis points as compared to the same period a year ago. Interest income increased 36.5% for the nine-month period ended September 30, 2005, as compared to the same period a year ago. The increase in interest income can be attributed to the yield on average interest-earning assets increasing to 6.15% as compared to 5.51% for the same period a year ago. In addition, the average balance of interest-earning assets increased 22.4% for the nine-month period ended September 30, 2005, as compared to the same period a year ago.

INTEREST EXPENSE

Interest expense increased 90.1% for the three-month period ended September 30, 2005, as compared to the same period a year ago. This increase was due to the average cost of interest-bearing liabilities increasing 97 basis points and the average balance of interest-bearing liabilities increasing 29.5% as compared to the same period a year ago. In the nine-month period ended September 30, 2005, interest expense increased 63.6% as compared to the same period a year ago. The average balance of interest-bearing liabilities increased 21.6% as compared to the same period a year ago. The cost of interest-bearing liabilities increased to 2.72% as compared to 2.02% for the same period last year.

NET INTEREST INCOME

Net interest income for the three and nine-month periods ended September 30, 2005, as compared to the same period a year ago, increased 29.4% and 23.1% respectively. The increase was due to interest-earning assets increasing more than interest-bearing liabilities. This can be attributed to the increase in noninterest bearing checking accounts and the retention of earnings.

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AVERAGE YIELD/COST ANALYSIS

The following table contains information relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such annualized yields and costs are derived by dividing income or expense by the average balances of assets or liabilities, respectively, for the periods presented. The average loan portfolio balances include nonaccrual loans.

For the quarter ended
SEPTEMBER 30, 2005

SEPT

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(DOLLARS IN THOUSANDS)

	Average Balance	Interest	Average Yield/ Cost	Average Balance
Interest-earning assets:				
Interest-bearing deposits in other banks	\$ 3,210	\$ 27	3.36%	\$ 3,845
Securities:				
Available for sale	43,435	499	4.60%	46,125
Held to maturity	2,290	26	4.54%	2,969
FHLB stock	5,667	46	3.25%	4,288
Loan portfolio	599,633	9,907	6.61%	447,644
Total interest-earning assets	654,235	10,505	6.42%	504,871
Non-interest earning assets	29,643			27,434
Total assets	\$ 683,878			\$ 532,305
Interest-bearing liabilities:				
Deposits	470,601	3,306	2.81%	360,823
Borrowed funds	114,472	1,158	4.05%	91,119
Total interest-bearing liabilities	585,073	\$ 4,464	3.05%	451,942
Non-interest bearing liabilities	48,876			35,141
Total liabilities	633,949			487,083
Stockholders' equity	49,929			45,222
Total liabilities and stockholders' equity	\$ 683,878			\$ 532,305
Net interest income		\$ 6,041		
Interest rate spread			3.37%	
Net yield on interest-earning assets			3.69%	
Percentage of average interest-earning assets to average interest-bearing liabilities			111.8%	

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For the nine months ended
SEPTEMBER 30, 2005

(DOLLARS IN THOUSANDS)

Average	Average Yield/	Average
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	Balance	Interest	Cost	Bala
	-----	-----	-----	-----
Interest-earning assets:				
Interest-bearing deposits in other banks	\$ 3,567	\$ 76	2.84%	\$
Securities:				
Available for sale	43,866	1,506	4.58%	
Held to maturity	2,467	86	4.65%	
FHLB stock	5,220	155	3.96%	
Loan portfolio	544,810	25,827	6.32%	4
	-----	-----		-----
Total interest-earning assets	599,930	\$27,650	6.15%	4

Non-interest earning assets	28,008			
	-----			-----
Total assets	\$ 627,938			\$ 5
	=====			=====
Interest-bearing liabilities:				
Deposits	435,037	8,150	2.50%	3
Borrowed funds	101,021	2,795	3.69%	
	-----	-----		-----
Total interest-bearing liabilities	536,058	\$ 10,945	2.72%	4

Non-interest bearing liabilities	43,864			
	-----			-----
Total liabilities	579,922			4
Stockholders' equity	48,016			
	-----			-----
Total liabilities and stockholders' equity	\$ 627,938			\$ 5
	=====			=====
Net interest income		\$ 16,705		
		=====		
Interest rate spread			3.43%	
			=====	
Net yield on interest-earning assets			3.71%	
Percentage of average interest-earning assets to average interest-bearing liabilities			111.9%	
			=====	

PROVISION AND ALLOWANCE FOR LOAN LOSSES

During the nine-month period ended September 30, 2005 the Bank had net charge-offs against the allowance for loan losses of \$59,000 compared to \$36,000 for the same period in 2004. The Bank added \$1.6 million to the allowance for loan losses for the current nine-month period as compared to \$745,000 for the same period last year, increasing the balance to \$5.8 million at September 30, 2005. The increase in the provision for loan losses was caused by the increase in the loan portfolio and the Bank's increased emphasis on commercial loans, which involve a higher degree of risk than one-to-four family mortgage loans.

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The asset quality of the Bank remained strong. The ratio of allowance for loan losses to total loans was 0.94% at September 30, 2005 as compared to 0.94% at December 31, 2004. Management considers the current level of the allowance to be appropriate based on asset classification, loan composition, the current level of delinquencies and other nonperforming assets, overall economic conditions and other factors. Future increases to the allowance may be necessary, however, due to changes in loan composition or loan volume, changes in economic or market area conditions and other factors. Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the recognition of adjustments to the allowance for loan losses based on their judgments of information available to them at the time of their examination.

NONINTEREST INCOME

Noninterest income increased by 8.8% for the nine-month period ended September 30, 2005, as compared to the same period a year ago. The change in noninterest income can be primarily attributed to service charges and fees on loans and deposit-related fees increasing \$300,000 and \$127,000 respectively. The rise in fees on loans was primarily caused by an increase in brokered loan fees. The deposit-related fees increase was principally caused by a boost in service charges on deposit accounts and ATM fees resulting from an increase in deposit accounts.

In the three-month period ended September 30, 2005, noninterest income increased 4.5% as compared to the same period last year. Service charges and fees on loans increased \$89,000 and deposit-related fees increased \$76,000 for the three-month period ended September 30, 2005 as compared to the same period a year ago. The reasons for these increases are the same as stated above for the nine-month period.

NONINTEREST EXPENSE

For the nine-month period ended September 30, 2005, noninterest expense increased 8.5% as compared to the same period last year. Compensation and fringe benefits increased \$706,000 due to increases in costs of benefits, staffing levels, incentive pay and normal increases in salaries. Occupancy and equipment increased \$157,000 caused by normal increases and the opening of the Operations and Training Center, a bank branch and a Lumina branch.

In the three-month period ended September 30, 2005, noninterest expense increased 11.5% as compared to the same period last year. This increase can primarily be attributed to increases in compensation and fringe benefits and occupancy and equipment expense of \$307,000 and \$77,000 respectively. The reasons for these changes are identical to the ones stated above for the nine-month period ended September 30, 2005.

INCOME TAXES

The effective tax rate for the nine-month periods ended September 30, 2005 and 2004 was 39.3% and 33.2% respectively. The effective tax rate for the three-month periods ended September 30, 2005 and 2004 was 41.2% and 33.1% respectively. The higher rate in 2005 resulted principally from an increase in the provision for income taxes. In addition to the business benefits resulting from the Company's formation of Holdings and REIT in 2002, there also resulted a reduction in state income taxes paid. State taxing authorities have recently announced that they will vigorously pursue taxpayers who have utilized certain organizational structures that result in reduced state income taxes, including the structure the Company utilized for Holdings and REIT. In response to that announcement the Company increased the provision for income taxes to provide for additional state income taxes. As of December 31, 2004, the Company estimated that the possible effect of the state's position could be as much as \$500,000,

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including interest and penalties, net of federal tax benefit. This estimate does not include periods after 2004 and is subject to change.

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NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document, as well as other written communications made from time to time by Cooperative Bankshares, Inc. and subsidiaries and oral communications made from time to time by authorized officers of the Company, may contain statements relating to the future results of the Company (including certain projections, such as earnings projections and business trends) that are considered "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995 (the PSLRA). Such forward-looking statements may be identified by the use of such words as "intend," "believe," "expect," "should," "planned," "estimated" and "potential." For these statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the PSLRA. The Company's ability to predict future results is inherently uncertain and the company cautions you that a number of important factors could cause actual results to differ materially from those currently anticipated in any forward-looking statement. These factors include among others; changes in market interest rates and general and regional economic conditions, changes in government regulations, changes in accounting principles and the quality or composition of the loan and investment portfolios and other factors that may be described in the Company's quarterly reports on Form 10-Q and in its annual report on Form 10-K, each filed with the Securities and Exchange Commission, which are available at the Securities and Exchange Commission's Internet website (www.sec.gov) and to which reference is hereby made. Stockholders are cautioned not to place undue reliance on such statements, which speak only as of the date of those documents. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements above. Except to the extent required by applicable law or regulation, the Company does not undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary market risk is interest rate risk. Interest rate risk is the result of differing maturities or repricing intervals of interest-earning assets and interest-bearing liabilities and the fact that rates on these financial instruments do not change uniformly. These conditions may impact the earnings generated by the Company's interest-earning assets or the cost of its interest-bearing liabilities, thus directly impacting the Company's overall earnings. The Company's management actively monitors and manages interest rate risk. One way this is accomplished is through the development of, and adherence to, the Company's asset/liability policy. This policy sets forth management's strategy for matching the risk characteristics of the Company's interest-earning assets and interest-bearing liabilities so as to mitigate the effect of changes in the rate environment. The Company's market risk profile has not changed materially since December 31, 2004.

ITEM 4 - CONTROLS AND PROCEDURES

The Company's management, including the Company's principal executive officer and principal financial officer, has evaluated the effectiveness of the Company's "disclosure controls and procedures", as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive

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officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. In addition, based on that evaluation, no change in the Company's internal control over financial reporting occurred during the quarter ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The Company did not purchase any shares of its common stock during the second quarter.

On August 30, 2005, the Company's wholly owned subsidiary, Cooperative Bankshares Capital Trust I ("Trust I"), issued \$15.5 million in trust preferred securities pursuant to exemptions from registration under Section 4(2) of the Securities Act of 1933, as amended (the "Act"), SEC Rule 506 under the Act, SEC Rule 144A under the Act and/or SEC Regulation S under the Act. The placement agent was Cohen Bros. & Company. The aggregate offering price of the capital securities was \$15.5 million. No commissions were paid to the placement agent. In exchange for the proceeds from the offering of the capital securities and the proceeds from the sale of Trust I's common securities, the Company issued \$15.5 million aggregate principal amount of junior subordinated debentures in an offering exempt from registration under Section 4(2) of the Act. The net proceeds of the offering totaled approximately \$15.0 million and were used for the following purposes: (1) a capital contribution to the Company's primary subsidiary, the Bank, of \$10 million to fund loan growth; and (2) investment in interest-earning assets and other corporate purposes in the amount of \$5.0 million.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY-HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

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Exhibit 3.1(1)	Articles of Incorporation
Exhibit 3.2(2)	Articles of Amendment to Articles of Incorporation
Exhibit 3.3(1)	Bylaws, as amended
Exhibit 10.1(3)	Indenture, Dated as of August 30, 2005 between Cooperative Banks and LaSalle Bank National Association, as Trustee
Exhibit 10.2(4)	Guarantee Agreement, dated as of August 30, 2005, by and between Cooperative Bankshares, Inc., as Guarantor, and LaSalle Bank National Association, as Guarantee Trustee
Exhibit 10.3(5)	Amended and Restated Declaration of Trust of Cooperative Bank Trust I
Exhibit 11.1	Statement re: Computation of Per Share Earnings (See note 3 to Unaudited Consolidated Financial Statements on page 8)
Exhibit 31.1	Rule 13a-14(a) Certification of Chief Executive Officer
Exhibit 31.2	Rule 13a-14(a) Certification of Chief Financial Officer
Exhibit 32	Certificate Pursuant to 18 U.S.C. Section 1350

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- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-4 (Reg. N) and any amendments thereto filed with the SEC.
- (2) Incorporated by reference to Registrant's Proxy Statement filed with the SEC on March 31, 2005.
- (3) Incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed with the SEC on August 31, 2005.
- (4) Incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed with the SEC on August 31, 2005.
- (5) Incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed with the SEC on August 31, 2005.

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SIGNATURES

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

Dated: November 9, 2005

Cooperative Bankshares, Inc.

/s/ Frederick Willetts, III

Frederick Willetts, III
President/Chief Executive Officer

Dated: November 9, 2005

/s/ Todd L. Sammons

Todd L. Sammons
Senior Vice President/Chief Financial Officer

