COOPERATIVE BANKSHARES INC
Form 10-Q
November 12, 2003

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2003

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 of 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.

[X] Yes [ ] No

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

[ ] Yes [X] 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. 2,849,447 shares at October 31, 2003

TABLE OF CONTENTS

			Page
Part I		Financial Information	
	Item 1	Financial Statements	
		Consolidated Statements of Financial Condition, September 30, 2003 and December 31, 2002	3
		Consolidated Statements of Operations, for the three and nine months ended September 30, 2003 and 2002	4
		Consolidated Statement of Stockholders' Equity, for the nine months ended September 30, 2003	5
		Consolidated Statements of Cash Flows, for the nine months ended September 30, 2003 and 2002	6-7
		Notes to Consolidated Financial Statements	8-10
	Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	10-19
	Item 3	Market Risk	19
	Item 4	Controls and Procedures	19
Part II		Other Information	
	Item 1	Legal Proceedings	20
	Item 2	Changes in Securities and Use of Proceeds	20
	Item 3	Defaults Upon Senior Securities	20
	Item 4	Submission of Matters to a Vote of Security Holders	20
	Item 5	Other Information	20
	Item 6	Exhibits and Reports on Form 8-K	20
		Signatures	21
		Exhibit 31.1	22
		Exhibit 31.2	23
		Exhibit 32	24

PART 1-FINANCIAL INFORMATION-FINANCIAL STATEMENTS
COOPERATIVE BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	SEPTEMBER 30, 2003	Decembe 2002
	(UNAUDITED)	
ASSETS		
Cash and due from banks, noninterest-bearing	$ 12,813,782	$ 11,858
Interest-bearing deposits in other banks	4,203,387	
Total cash and cash equivalents	17,017,169	11,858
Securities:		
Available for sale (amortized cost of $43,960,375 in September 2003 and $41,033,409 in December 2002)	44,570,080	42,075
Held to maturity (estimated market value of $4,102,965 in September 2003 and $8,009,087 in December 2002)	4,007,310	7,859
FHLB stock	3,904,500	4,054
Loans held for sale	13,362,419	25,659
Loans	392,081,725	393,812
Less allowance for loan losses	3,283,963	2,936
Net loans	388,797,762	390,876
Other real estate owned	519,320	619
Accrued interest receivable	2,033,905	2,239
Premises and equipment, net	8,492,068	7,019
Goodwill	1,461,543	661
Other assets	12,221,071	11,285
Total assets	$496,387,147	$504,209
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$362,967,228	$357,254
Short-term borrowings	45,009,605	61,585
Escrow deposits	343,247	223
Accrued interest payable	228,854	284
Accrued expenses and other liabilities	2,512,621	3,320
Long-term obligations	43,089,000	43,092
Total liabilities	454,150,555	465,761
Stockholders' equity:		
Preferred stock, $1 par value, 3,000,000 shares authorized, no shares issued and outstanding	--	
Common stock, $1 par value, 7,000,000 shares authorized, 2,849,447 and 2,835,947 shares issued and outstanding	2,849,447	2,835
Additional paid-in capital	2,634,542	2,440
Accumulated other comprehensive income	402,405	635
Retained earnings	36,350,198	32,536
Total stockholders' equity	42,236,592	38,448
Total liabilities and stockholders' equity	$496,387,147	$504,209
Book value per common share	$ 14.82	$ 1

============ ========

*Derived from audited consolidated financial statements.
The accompanying notes are an integral part of the consolidated financial statements.

3

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002	2003	2002
INTEREST INCOME:				
Loans	$ 6,377,688	$ 6,682,082	$19,438,132	$19,930,
Securities	451,502	610,326	1,583,490	1,980,
Other	14,410	18,473	38,400	42,
Dividends on FHLB stock	29,554	54,981	112,978	168,
Total interest income	6,873,154	7,365,862	21,173,000	22,121,
INTEREST EXPENSE:				
Deposits	1,756,670	2,462,594	5,698,997	7,918,
Borrowed funds	882,897	917,751	2,664,796	2,722,
Total interest expense	2,639,567	3,380,345	8,363,793	10,640,
NET INTEREST INCOME	4,233,587	3,985,517	12,809,207	11,481,
Provision for loan losses	180,000	120,000	560,000	520,
Net interest income after provision for loan losses	4,053,587	3,865,517	12,249,207	10,961,
NONINTEREST INCOME:				
Gain on sale of loans	1,230,255	704,043	3,489,333	765,
Net gain on sale of securities	--	--	--	135,
Service charges and fees on loans	115,797	140,280	369,015	478,
Deposit-related fees	354,046	259,586	987,561	770,
Gain on sale of real estate	--	--	--	464,
Bank-owned life insurance earnings	91,506	85,658	278,490	285,
Other income, net	52,940	84,664	146,944	187,
Total noninterest income	1,844,544	1,274,231	5,271,343	3,087,
NONINTEREST EXPENSE:				
Compensation and fringe benefits	2,341,495	2,083,599	7,101,557	5,053,
Occupancy and equipment	690,012	619,565	1,997,581	1,686,
Professional and examination fees	38,058	63,438	251,766	293,
Advertising	169,590	103,043	435,687	239,
Real estate owned	26,137	(1,267)	59,677	9,
Other	490,369	408,809	1,407,395	1,155,

Total noninterest expenses	3,755,661	3,277,187	11,253,663	8,438,
Income before income taxes	2,142,470	1,862,561	6,266,887	5,610,
Income tax expense	712,063	642,682	2,025,591	1,970,
NET INCOME	$ 1,430,407	$ 1,219,879	$ 4,241,296	$ 3,639,
NET INCOME PER SHARE:				
Basic	$ 0.50	$ 0.43	$ 1.49	$ 1
Diluted	$ 0.49	$ 0.43	$ 1.47	$ 1
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic	2,848,197	2,835,947	2,846,941	2,835,
Diluted	2,901,844	2,861,290	2,895,058	2,856,

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	RETAINED EARNINGS
Balance, December 31, 2002	$ 2,835,947	$ 2,440,645	$ 635,500	$ 32,536,1
Exercise of stock options	13,500	173,590	--	
Tax benefit of stock option exercise	--	20,307	--	
Other comprehensive loss, net of taxes	--	--	(233,095)	
Net income	--	--	--	4,241,2
Cash dividends ($.15 per share)	--	--	--	(427,2
Balance, September 30, 2003	$ 2,849,447	$ 2,634,542	$ 402,405	$ 36,350,1

The accompanying notes are an integral part of the consolidated financial statements.

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

	NINE MONTHS ENDED SEPTEMBER 30 2003	2002
OPERATING ACTIVITIES:		
Net income	$ 4,241,296	$ 3,639,543
Adjustments to reconcile net income to net cash used in operating activities:		
Net accretion, amortization, and depreciation	1,013,541	791,310
Net gain on sale of securities	--	(135,182)
Gain on sale of loans	(3,489,333)	(765,385)
Deferred income taxes	(272,710)	49,499
Gain on sale of premises and equipment	--	(464,977)
Loss (gain) on sales of foreclosed real estate	24,527	(6,855)
Valuation losses on foreclosed real estate	116,543	108,446
Provision for loan losses	560,000	520,000
Proceeds from sale of loans	226,985,153	37,347,800
Loan originations held for sale	(211,332,970)	(54,867,693)
Changes in assets and liabilities:		
Accrued interest receivable	205,921	321,744
Other assets	(464,081)	(328,818)
Accrued interest payable	(55,714)	(149,509)
Accrued expenses and other liabilities	(1,187,701)	3,023,703
Net cash provided (used) in operating activities	16,344,472	(10,916,374)
INVESTING ACTIVITIES:		
Purchases of securities available for sale	(13,489,375)	(22,717,557)
Purchases of securities held to maturity	(2,981,944)	(4,165,348)
Purchase of Lumina Mortgage Company	(400,000)	(773,188)
Proceeds from sale of securities available for sale	1,650,200	19,058,014
Proceeds from maturity of securities available for sale	--	4,802,669
Proceeds from maturity of securities held to maturity	5,000,000	--
Repayments of mortgage-backed securities available for sale	8,870,067	--
Repayments of mortgage-backed securities held to maturity	1,679,191	--
Loan originations, net of principal repayments	1,245,586	(14,047,379)
Proceeds from disposals of foreclosed real estate	374,471	204,766
Additions to other real estate owned	(8,236)	(101,455)
Purchases of premises and equipment	(2,140,341)	(1,217,422)
Proceeds from sale of premises and equipment	1,691	499,070
Net cash used in investing activities	(198,690)	(18,457,830)
FINANCING ACTIVITIES:		
Net increase in deposits	5,713,132	20,042,822
Net change in short-term borrowings	(16,576,222)	18,039,188
Net change in long-term obligations	(3,592)	(5,003,400)
Proceeds from issuance of common stock, net	187,090	5,424
Dividends	(427,267)	(425,095)
Net change in escrow deposits	119,643	509,520
Net cash provided (used) by financing activities	(10,987,216)	33,168,459

INCREASE IN CASH AND CASH EQUIVALENTS	5,158,566	3,794,255
CASH AND CASH EQUIVALENTS:		
BEGINNING OF PERIOD	11,858,603	12,295,578
END OF PERIOD	$ 17,017,169	$ 16,089,833

(Continued)

CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

	NINE MONTHS ENDED SEPTEMBER 30, 2003	2002
Cash paid for:		
Interest	$ 8,419,507	$ 10,789,953
Income taxes	2,388,352	1,857,763
Summary of noncash investing and financing activities:		
Transfer from loans to foreclosed real estate	479,462	963,668
Loans to facilitate the sale of foreclosed real estate	72,000	918,450
Unrealized gain (loss) on securities available for sale, net of taxes	(233,095)	227,136
Accrual of goodwill for purchase of Lumina Mortgage Company	800,000	--
Reclassifications between long-term obligations and short-term borrowings	15,000,000	15,000,000

The accompanying notes are an integral part of the consolidated financial statements.

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 for the year ended December 31, 2002 (the "Annual Report"). The results of operations for the nine-month period ended September 30, 2003 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. 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. Earnings Per Share: Earnings per share (EPS) are 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:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002	2003	2002
Net income (numerator)	$1,430,407	$1,219,879	$4,241,296	$3,639,543
Shares for basic EPS (denominator)	2,848,197	2,835,947	2,846,941	2,835,634
Dilutive effect of stock options	53,647	25,343	48,117	20,449
Shares for diluted EPS (denominator)	2,901,844	2,861,290	2,895,058	2,856,083

For the nine months ended September 30, 2003 and 2002, there were 0 and 14,204 options outstanding respectively that were antidilutive since the exercise price exceeds the average market price. The options have been omitted from the calculation of the dilutive effect of stock options.

8

4. 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:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MON SEPTEM
	2003	2002	2003

Net income	$ 1,430,407	$ 1,219,879	$ 4,241,296
Other comprehensive income			
Realized (gains) losses on available for sale securities	--	--	--
Unrealized gains (losses) on available for sale securities	(145,278)	346,469	(432,098)
Income taxes	49,395	(135,123)	199,003
Other comprehensive income (loss)	(95,883)	211,346	(233,095)
Comprehensive income	$ 1,334,524	$ 1,431,225	$ 4,008,201

5. 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.

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2003	2002	2003	2002
Net income, as reported	$ 1,430,407	$1,219,879	$ 4,241,296	$ 3,639,5
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	--	--	--	(60,5
Pro forma net income	$ 1,430,407	$1,219,879	$ 4,241,296	$ 3,579,0
Earnings per share:				
Basic-as reported	$ 0.50	$ 0.43	$ 1.49	$ 1.
Basic-pro forma	$ 0.50	$ 0.43	$ 1.49	$ 1.
Diluted-as reported	$ 0.49	$ 0.43	$ 1.47	$ 1.
Diluted-pro forma	$ 0.49	$ 0.43	$ 1.47	$ 1.

9

6. Acquisition: On May 31, 2002, the Bank acquired the operating assets of Wilmington-based Lumina Mortgage Company. The purchase price was $740,000 in cash with two future contingent payments based on loan origination volume and meeting certain profitability goals of Lumina. The agreement was

subsequently amended to change the contingent payments into two payments of $400,000 each payable on July 31, 2003 and 2004. These payments are considered additional purchase price and accordingly, goodwill related to this acquisition was increased by $800,000.

7. New Accounting Pronouncements: On January 1, 2003, the Company adopted SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity." The adoption of SFAS No. 146 did not have a material effect on the Company's consolidated financial statements.

   In November 2002, the Financial Accounting Standards Board (FASB) issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34." This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and did not have a material effect on the Company's consolidated financial statements. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002.

   In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of ARB No. 51". This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. For public enterprises with a variable interest in a variable interest entity created before February 1, 2003, the interpretation applies to that enterprise no later than the beginning of the first interim or annual reporting period beginning after December 15, 2003. The application of this Interpretation is not expected to have a material effect on the Company's consolidated financial statements. The Interpretation requires certain disclosures in financial statements issued after January 31, 2003 if it is reasonably possible that the Company will consolidate or disclose information about variable interest entities when the Interpretation becomes effective.

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. Cooperative Bank, headquartered in Wilmington, North Carolina, was chartered in 1898. The Bank provides financial services through 18 financial centers in Eastern North Carolina and a loan origination office in Corolla, 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 offices in Wilmington, North Carolina; North Myrtle Beach, South Carolina; and Virginia Beach, Virginia. The Bank's other subsidiary, CS&L Holdings, Inc. ("Holdings"), is a holding company for CS&L Real Estate Trust, Inc. (the "REIT"), which is a real estate investment trust.

Through its financial centers, the Bank provides a wide range of banking products, including interest-bearing and non-interest-bearing checking accounts, certificates of deposit and individual retirement accounts, which are insured up to the applicable limits of the Federal Deposit Insurance Corporation ("FDIC"). 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, ATMs and Access24 Phone Banking. The Bank began offering Online Banking and Bill Payment on July 1, 2003. In addition, the Bank offers discount brokerage services, annuity sales and mutual funds through a third party arrangement with UVEST Investment Services. Lumina delivers a wide range of mortgage loan products to its market area.

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

Cooperative 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 however, the Bank has emphasized origination of nonresidential real estate loans and secured and unsecured consumer and business loans. As of September 30, 2003, approximately $260 million, or 66%, of the Bank's loan portfolio, which excludes loans held for sale, consisted of loans secured by residential properties. This compared to approximately $268 million, or 69% at December 31, 2002. The Bank originates adjustable rate and fixed rate loans. As of September 30, 2003, adjustable rate and fixed rate loans totaled approximately 66.9% and 33.1%, respectively, of the Bank's total loan portfolio.

The Bank has chosen to sell a larger percentage of its fixed rate mortgage loan originations in the secondary market and through brokered arrangements. This enables the Bank to reinvest these funds in commercial loans, while increasing fee income. This is part of the continuing effort to restructure the balance sheet and operations to be more reflective of a commercial bank.

The Bank opened additional branches in Wilmington, North Carolina on May 12, 2003 and Morehead City, North Carolina on July 1, 2003. The Bank expects to open additional branches in Wilmington and Southport, North Carolina around the end of 2003.

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 exceed the amount of interest rate sensitive liabilities. Gap is considered negative when the amount of interest rate sensitive liabilities exceed the amount of interest rate sensitive assets. At September 30, 2003, Cooperative had a one-year gap position of 0.0%. 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 using a 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 of these transaction accounts. Management takes this into consideration in determining acceptable levels of interest rate risk.

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

11

because any commitments 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.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Bank enters into agreements that obligate it to make future payments under contracts, such as debt and lease agreements. In addition, the Bank commits to lend funds in the future such as credit lines and loan commitments. Below is a table of such contractual obligations and commitments at September 30, 2003 (in thousands).

	Payments Due by Period				
Contractual Obligations	Total	Less than 1 year	1-3 years	4-5 years	Over 5 years
Borrowed Funds	$ 88,099	$ 45,010	$ 10,000	$ 10,000	$ 23,089
Lease Obligations	4,885	381	618	492	3,394
Lumina Mortgage Company Purchase	400	400	--	--	--
Deposits	362,967	327,827	34,958	182	--
Total Contractual Cash Obligations	$456,351	$373,618	$ 45,576	$ 10,674	$ 26,483

Other Commitments	Total Amounts Committed	Less than 1 year	1-3 years	4-5 years	Over 5 years
	Amount of Commitment Expiration Per Period				
Undisbursed portion of home equity collateralized primarily by junior liens on 1-4 family properties	$15,590	$ 651	$ 1,522	$ 537	$12,880
Other commitments and credit lines	14,144	3,366	7,674	79	3,025
Undisbursed portion of construction loans	39,737	39,737	--	--	--
Available for sale mortgage loan commitments	4,317	4,317	--	--	--
Fixed-rate mortgage loan commitments	1,973	1,973	--	--	--
Adjustable-rate mortgage loan commitments	5,347	5,347	--	--	--
Total Commitments	$81,108	$55,391	$ 9,196	$ 616	$15,905

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, 2003, the Bank's borrowed funds from the FHLB equaled 15.1% 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.

At September 30, 2003, the estimated market value of liquid assets (cash, cash equivalents, marketable securities and loans held for sale) was approximately $79.1 million, which represents 17.5% of deposits and borrowed funds as compared to $87.6 million or 19.0% of deposits and borrowed funds at December 31, 2002. The decrease in liquid assets was primarily due to a decrease in loans held for sale.

The Company's primary uses of liquidity are to fund loans and to make investments. At September 30, 2003, outstanding off-balance sheet commitments to extend credit totaled $41.4 million, and the undisbursed portion of construction loans was $39.7 million. Management considers current liquidity levels adequate to meet the Company's cash flow requirements.

CAPITAL

Stockholders' equity at September 30, 2003, was $42.2 million, up 9.9% from $38.4 million at December 31, 2002. Stockholders' equity at September 30, 2003, includes an unrealized gain net of tax, of $402,405 as compared to an unrealized gain net of tax at December 31, 2002, of $635,500 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, 2003, the Bank's ratio of Tier I capital was 7.96%. 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, 2003, the Bank had a ratio of qualifying total capital to risk-weighted assets of 12.02%.

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.

On September 24, 2003, the Company's Board of Directors approved a quarterly cash dividend of $0.05 per share. The dividend was paid on October 16, 2003 to stockholders of record as of October 1, 2003. This brings the total dividend for the year to $0.15 per share. 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.

CRITICAL ACCOUNTING POLICY

The Bank's most significant critical accounting policy is the determination of its allowance for loan losses. A critical accounting policy is one that is both very important to the portrayal of the Bank's financial condition and results, and requires management's most difficult, subjective or complex judgments. 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 "Financial Condition" in Management's Discussion and Analysis and Note 3 of "Notes to Consolidated Financial Statements" included in the Annual Report.

FINANCIAL CONDITION AT SEPTEMBER 30, 2003, COMPARED TO DECEMBER 31, 2002

The Company's total assets decreased 1.6% to $496.4 million at September 30, 2003, as compared to $504.2 million at December 31, 2002. The major change in assets is a decrease of $12.3 million (47.9%) in loans held for sale due to the decrease in mortgage volume caused by an increase in mortgage rates. This reduction along with the maturing of a held to maturity bond allowed the Bank to reduce short-term borrowings $16.6 million (26.9%). In addition there is an increase of $5.2 million (43.5%) in cash and cash equivalents, which was caused by an increase in deposits of $5.7 million (1.6%). The increase in deposits was mainly in the fifteen month certificate and non-interest-bearing checking. The increase in the fifteen month certificate was due to the Bank offering a good rate on a reasonably short term deposit. The Bank continues to emphasize obtaining business accounts, which is the reason

for the checking account increase. The Bank also attracted an additional $5.5 million in internet deposits because the rates were competitive with the Bank's local markets. Internet deposits are usually obtained from other financial institutions with terms primarily of one or two years. Borrowed funds, collateralized through an agreement with the FHLB for advances, are secured by the Bank's investment in FHLB stock and qualifying first mortgage loans. The increase of $1.5 million in premises and equipment, during this same period, was primarily due to the building and furnishing of new branches. Other assets increased $1.7 million (14.5%) largely due to an increase of $475,106 in deferred income taxes and an increase of $800,000 in goodwill. The additional goodwill was created by amending the purchase agreement of Lumina Mortgage Company from two contingent payments into two payments of $400,000 each payable on July 31, 2003 and 2004. A reduction in accounts payable caused the decrease of $808,008 in accrued expenses and other liabilities from December 31, 2002 to September 30, 2003

The Company's non-performing assets (loans 90 days or more delinquent and foreclosed real estate) were $1.1 million, or .22% of assets, at September 30, 2003, compared to $1.2 million, or .24% of assets, at December 31, 2002. Foreclosed real estate decreased to $519,320 at September 30, 2003, from $619,163 at December 31, 2002. The Company assumes an aggressive position in collecting delinquent loans and disposing of foreclosed assets to minimize balances of non-performing 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 declined because of the actions the Federal Reserve has taken since 2001 to reduce interest rates in hopes of spurring the economy.

NET INCOME

Net income for the three and nine-month periods ended September 30, 2003, increased 17.3% to $1.4 million and 16.5% to $4.2 million respectively, as compared to the same periods last year. The increase in net income for the nine-month period ended September 30, 2003 can be attributed to increases in net interest income of $1.3 million and non-interest income of $2.2 million. These changes were partially offset by an increase in non-interest expense of $2.8 million during the same period.

INTEREST INCOME

For the three-month period ended September 30, 2003, interest income decreased 6.7% as compared to the same period a year ago. The average balance of interest-earning assets increased 7.0% but the average yield decreased 84 basis points as compared to the same period a year ago. Interest income decreased 4.3% for the nine-month period ended September 30, 2003, as compared to the same period a year ago. The decrease in interest income can be attributed to the yield on average interest-earning assets decreasing to 5.91% as compared to 6.72% for the same period a year ago. The average balance of interest-earning assets increased 8.9% for the nine month period ended September 30, 2003, as compared to the same period a year ago. The increase in the average balance of interest-earning assets had a positive effect on interest income while the reduction in yield had a negative impact on interest income.

INTEREST EXPENSE

Interest expense decreased 21.9% for the three-month period ended September 30, 2003, as compared to the same period a year ago. This decrease was due to the average cost of interest-bearing liabilities decreasing 82 basis points as compared to the same period a year ago. In the nine-month period ended September 30, 2003, interest expense decreased 21.4% as compared to the same period a year ago. The average balance of interest-bearing liabilities

increased 6.7% as compared to the same period a year ago. The cost of interest-bearing liabilities decreased to 2.54% as compared to 3.45% for the same period last year.

NET INTEREST INCOME

Net interest income for the three and nine-month periods ended September 30, 2003, as compared to the same period a year ago, increased 6.2% and 11.6% respectively. The increase was due to interest-earning assets increasing faster than interest-bearing liabilities. In addition, there was a larger decrease in the cost of liabilities versus the yield on assets in the nine-month period, which can be attributed to the fact that deposits continued to reprice at lower yields caused by the Federal Reserve's previous rate reductions and the increased use of low cost borrowings due to the Lumina purchase. See "Average Yield/Cost Analysis" table for further information on interest income and interest expense.

AVERAGE YIELD/COST ANALYSIS

The following tables contain 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, 2003			SEPTEMBER 30, 200	
(DOLLARS IN THOUSANDS)	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest
Interest-earning assets:					
Interest-bearing deposits in other banks	$ 5,487	$ 14	1.02%	$ 3,512	$ 18
Securities:					
Available for sale	40,949	440	4.30%	39,212	504
Held to maturity	5,681	11	0.77%	8,460	107
FHLB stock	3,614	30	3.32%	4,155	55
Loan portfolio	425,569	6,378	5.99%	394,554	6,682
Total interest-earning assets	481,300	6,873	5.71%	449,893	7,366
Non-interest earning assets	28,449			27,670	

Total assets	$509,749			$477,563	
Interest-bearing liabilities:					
Deposits	342,492	1,757	2.05%	339,539	2,462
Borrowed funds	96,694	883	3.65%	80,120	918
Total interest-bearing liabilities	439,186	$2,640	2.40%	419,659	$3,380
Non-interest bearing liabilities	28,685			21,185	
Total liabilities	467,871			440,844	
Stockholders' equity	41,878			36,719	
Total liabilities and stockholders' equity	$509,749			$477,563	
Net interest income		$ 4,233			$ 3,986
Interest rate spread			3.31%		
Net yield on interest-earning assets			3.52%		
Percentage of average interest-earning assets to average interest-bearing liabilities			109.6%		

(Dollars in thousands)	SEPTEMBER 30, 2003 Average Balance	Interest	Average Yield/ Cost	SEPTEM Average Balance	Int
Interest-earning assets:					
Interest-bearing deposits in other banks	$ 4,675	$ 38	1.08%	$ 3,150	$
Securities:					
Available for sale	39,668	1,370	4.60%	41,260	1,
Held to maturity	6,906	213	4.11%	6,892	
FHLB stock	3,845	113	3.92%	4,155	
Loan portfolio	422,892	19,439	6.13%	383,306	19,
Total interest-earning assets	477,986	$ 21,173	5.91%	438,763	$ 22,

For the nine months ended (spanning header above both period column groups)

Non-interest earning assets	27,525			26,855	
Total assets	$505,511			$465,618	
Interest-bearing liabilities:					
Deposits	345,212	5,699	2.20%	334,185	7,
Borrowed funds	93,656	2,665	3.79%	77,002	2,
Total interest-bearing liabilities	438,868	$ 8,364	2.54%	411,187	$ 10,
Non-interest bearing liabilities	26,173			19,047	
Total liabilities	465,041			430,234	
Stockholders' equity	40,470			35,384	
Total liabilities and stockholders' equity	$505,511			$465,618	
Net interest income		$ 12,809			$ 11,
Interest rate spread			3.37%		
Net yield on interest-earning assets			3.57%		
Percentage of average interest-earning assets to average interest-bearing liabilities			108.9%		

PROVISION AND ALLOWANCE FOR LOAN LOSSES

During the nine-month period ended September 30, 2003 the Bank had net charge-offs against the allowance for loan losses of $212,832 compared to $340,613 for the same period in 2002. This decrease was primarily due to one larger credit being charged off during the first quarter of 2002. The Bank added $560,000 to the allowance for loan losses for the current nine-month period increasing the balance to $3.3 million at September 30, 2003. Management considers the current level of the allowance to be appropriate based on loan composition, the current level of delinquencies and other non-performing 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 70.8% for the nine-month period ended September 30, 2003, as compared to the same period a year ago. The change in noninterest income can be attributed to gain on sale of loans increasing over $2.7 million primarily as a result of the purchase of Lumina and the large volume of mortgage loans made in 2003 due to low interest rates. The Bank has also started to sell a larger percentage of its fixed rate mortgage loan originations in the secondary market instead of through brokered arrangements. This change causes an increase in gain on sale of loans and a reduction to service charges and fees on loans. Deposit related fees increased 28.2% primarily due to a new service the Bank offered beginning in April 2003, for checking accounts with non-sufficient funds. During the first nine months of 2002 the Bank sold a parking lot for $500,000, resulting in the gain on sale of real estate, and the gain of $135,182 on sale of securities was due to selling bonds and purchasing mortgage backed securities to give the Bank greater cash flow. No similar transactions occurred during the nine months ended September 30, 2003.

In the three-month period ended September 30, 2003, noninterest income increased 44.8% as compared to the same period last year. The net gains on sale of loans and deposit-related fees increased $526,212 and $94,460 respectively, for the three-month period ended September 30, 2003 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. The reason for the decrease of $24,483 in service charges and fees on loans during this period is due to having fewer loans being sold through brokered arrangements. Other income has declined $31,724 during the three-month period ended September 30, 2003 as compared to the same period a year ago mainly due to less income from our third party brokerage service.

NONINTEREST EXPENSE

For the nine-month period ended September 30, 2003, noninterest expense increased 33.4% as compared to the same period last year. Compensation and related costs increased 40.5%. Higher personnel costs associated with the purchase of Lumina accounted for the majority of the increase. Also, in January 2003, the Company granted 117 shares of preferred stock in the REIT to officers, directors, and Bank employees with at least one month of service and certain other parties. Each individual that was granted the preferred stock received one share that had a $500 value, for an aggregate increase to compensation expense of $58,500. In addition, the increase was due to increases in costs of benefits, staffing levels, including the staffing for additional branches, incentive pay and normal increases in salaries. Occupancy and equipment expense increased $310,622 primarily because of the Lumina purchase and an increase in depreciation and other expenses due to the new branches and upgrades in hardware and software systems. The increase in advertising and other noninterest expenses of $195,824 and $252,225 respectively, was mainly due to the purchase of Lumina and the opening of two new branches. Real estate owned expense increased $50,407 primarily due to losses and expenses incurred in disposing properties.

In the three-month period ended September 30, 2003, noninterest expense increased 14.6% as compared to the same period last year. This increase can be principally attributed to compensation and fringe benefits, occupancy and equipment expense, advertising, real estate owned and other expense increasing $257,896, $70,447, $66,547, $27,404 and $81,560 respectively. The reasons for the rise in compensation and fringe benefits was mainly due to increases in cost of benefits, staffing levels, including the staffing for additional branches, incentive pay and normal

18

increases in salaries. Occupancy and equipment expense increased primarily because of the expenses associated with the new branches. Lumina had a more aggressive advertising campaign during this quarter and the promotion of our new branches and investor relations expenses were the main reasons for the boost in advertising expense. Real estate owned expense increased generally because of the costs associated with disposing of the real estate. The rise in other expenses was caused by an increase in contributions and expenses related to the new branches. In addition, a large recovery of a bad debt was received during the three-month period ended September 30, 2002.

INCOME TAXES

The effective tax rate for the nine-month periods ended September 30, 2003 and 2002, was 32.3% and 35.1% respectively. The effective tax rate for the three-month periods ended September 30, 2003 and 2002 was 33.2% and 34.5% respectively. The decreases resulted from the formation of Holdings and the REIT in December 2002.

NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information contained herein, the discussion contains forward-looking statements that involve risks and uncertainties. Economic circumstances, the Company's operations, and the Company's actual results could differ significantly from those discussed in the forward-looking statements. Some of the factors that could cause or contribute to such differences are discussed herein, but also include changes in the economy and interest rates in the nation, changes in the Company's regulatory environment and the Company's market area.

ITEM 3 - 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 liabilities so as to mitigate the effect of changes in the rate environment. The Company's market risk profile has not changed significantly since December 31, 2002.

ITEM 4 - CONTROLS AND PROCEDURES

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the Company's disclosure controls and procedures (as such term is defined in Rule 13a-14(c) under the Exchange Act) as of the end of the period covered by this Form 10-Q. Based upon such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls during the quarter ended September 30, 2003.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(a) Not applicable

(b) Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

(a) Not applicable

(b) Not applicable

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

Not applicable

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit 31.1 Section 302 Certification of the Chief Executive Officer

Exhibit 31.2 Section 302 Certification of the Chief Financial Officer

Exhibit 32 Certificate Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K.

The Company filed a current Report on Form 8-K dated October 23, 2003 to report third quarter earnings.

20

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 12, 2003	Cooperative Bankshares, Inc.
	/s/ Frederick Willetts, III
	Frederick Willetts, III President/Chief Executive Officer
Dated: November 12, 2003	/s/ Todd L. Sammons
	Todd L. Sammons Senior Vice President/Chief Financial Officer