

TEXAS CAPITAL BANCSHARES INC/TX

Form 10-Q

October 30, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended September 30, 2008**

**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 0-30533**

**TEXAS CAPITAL BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**75-2679109**

(I.R.S. Employer Identification Number)

**2100 McKinney Avenue, Suite 900, Dallas, Texas,**

**U.S.A.**

(Address of principal executive officers)

**75201**

(Zip Code)

**214/932-6600**

(Registrant's telephone number, including area code)

**N/A**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Non-Accelerated Filer

(Do not check if a smaller reporting company)

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:**

On October, 28 2008, the number of shares set forth below was outstanding with respect to each of the issuer's classes of common stock:

Common Stock, par value \$0.01 per share

30,849,513

Texas Capital Bancshares, Inc.  
Form 10-Q  
Quarter Ended September 30, 2008  
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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****TEXAS CAPITAL BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS UNAUDITED**

(In thousands except per share data)

|  | Three months ended<br>September 30 |          | Nine months ended<br>September 30 |           |
|--|------------------------------------|----------|-----------------------------------|-----------|
|  | 2008                               | 2007     | 2008                              | 2007      |
| <b>Interest income</b>                                     |                                    |          |                                   |           |
| Interest and fees on loans                                 | \$57,909                           | \$70,719 | \$176,195                         | \$198,419 |
| Securities   | 4,281                              | 5,395    | 13,691                            | 16,784    |
| Federal funds sold   | 40                                 | 12       | 141                               | 27        |
| Deposits in other banks                                    | 10                                 | 14       | 30                                | 44        |
| Total interest income                                      | 62,240                             | 76,140   | 190,057                           | 215,274   |
| <b>Interest expense</b>                                    |                                    |          |                                   |           |
| Deposits   | 18,338                             | 32,690   | 56,777                            | 93,311    |
| Federal funds purchased                                    | 2,273                              | 3,554    | 7,186                             | 9,474     |
| Repurchase agreements                                      | 86                                 | 175      | 462                               | 839       |
| Other borrowings   | 1,791                              | 1,102    | 7,770                             | 3,231     |
| Trust preferred subordinated debentures                    | 1,486                              | 2,088    | 4,837                             | 6,198     |
| Total interest expense                                     | 23,974                             | 39,609   | 77,032                            | 113,053   |
| <b>Net interest income</b>                                 | 38,266                             | 36,531   | 113,025                           | 102,221   |
| <b>Provision for loan losses</b>                           | 4,000                              | 2,000    | 15,750                            | 4,700     |
| <b>Net interest income after provision for loan losses</b> | 34,266                             | 34,531   | 97,275                            | 97,521    |
| <b>Non-interest income</b>                                 |                                    |          |                                   |           |
| Service charges on deposit accounts                        | 1,161                              | 1,089    | 3,566                             | 2,935     |
| Trust fee income   | 1,234                              | 1,182    | 3,656                             | 3,453     |
| Bank owned life insurance (BOLI) income                    | 299                                | 288      | 925                               | 887       |
| Brokered loan fees   | 1,024                              | 452      | 2,168                             | 1,505     |
| Equipment rental income                                    | 1,487                              | 1,581    | 4,513                             | 4,533     |
| Other  | (320)                              | 55       | 1,692                             | 2,434     |
| Total non-interest income                                  | 4,885                              | 4,647    | 16,520                            | 15,747    |
| <b>Non-interest expense</b>                                |                                    |          |                                   |           |
| Salaries and employee benefits                             | 16,039                             | 15,254   | 46,750                            | 44,573    |
| Net occupancy expense                                      | 2,300                              | 2,194    | 7,097                             | 6,269     |
| Leased equipment depreciation                              | 1,153                              | 1,311    | 3,525                             | 3,722     |
| Marketing  | 521                                | 669      | 1,847                             | 2,154     |
| Legal and professional                                     | 2,338                              | 1,799    | 6,829                             | 5,202     |
| Communications and data processing                         | 804                                | 849      | 2,428                             | 2,519     |
| Other  | 4,520                              | 3,818    | 12,732                            | 10,961    |

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|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| Total non-interest expense                                   | 27,675   | 25,894   | 81,208    | 75,400    |
| <b>Income from continuing operations before income taxes</b> | 11,476   | 13,512   | 32,587    | 37,868    |
| Income tax expense   | 3,911    | 4,668    | 11,192    | 13,053    |
| <b>Income from continuing operations</b>                     | 7,565    | 8,844    | 21,395    | 24,815    |
| <b>Loss from discontinued operations (after-tax)</b>         | (252)    | (602)    | (516)     | (746)     |
| <b>Net income</b>  | \$ 7,313 | \$ 8,242 | \$ 20,879 | \$ 24,069 |
| <b>Basic earnings per share:</b>                             |          |          |           |           |
| Income from continuing operations                            | \$ .27   | \$ .34   | \$ .79    | \$ .95    |
| Net income   | \$ .26   | \$ .31   | \$ .77    | \$ .92    |
| <b>Diluted earnings per share:</b>                           |          |          |           |           |
| Income from continuing operations                            | \$ .27   | \$ .33   | \$ .79    | \$ .93    |
| Net income   | \$ .26   | \$ .31   | \$ .77    | \$ .90    |

See accompanying notes to consolidated financial statements.

**Table of Contents****TEXAS CAPITAL BANCSHARES, INC.  
CONSOLIDATED BALANCE SHEETS**

(In thousands except per share data)

|   | September<br>30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|---|---|----------------------|
| <b>Assets</b>   |   |                      |
| Cash and due from banks   | \$ 64,738                               | \$ 89,463            |
| Federal funds sold  | 3,050                                   |                      |
| Securities, available-for-sale  | 365,145                                 | 440,119              |
| Loans held for sale   | 343,002                                 | 174,166              |
| Loans held for sale from discontinued operations  | 648                                     | 731                  |
| Loans held for investment (net of unearned income)  | 3,840,172                               | 3,462,608            |
| Less: Allowance for loan losses   | 40,998                                  | 32,821               |
| Loans held for investment, net  | 3,799,174                               | 3,429,787            |
| Premises and equipment, net   | 26,683                                  | 31,684               |
| Accrued interest receivable and other assets  | 132,522                                 | 113,648              |
| Goodwill and intangible assets, net   | 7,729                                   | 7,851                |
| Total assets  | \$ 4,742,691                            | \$ 4,287,449         |
| <b>Liabilities and Stockholders Equity</b>  |   |                      |
| Liabilities:  |   |                      |
| Deposits:   |   |                      |
| Non-interest bearing  | \$ 561,227                              | \$ 529,334           |
| Interest bearing  | 2,143,944                               | 1,569,546            |
| Interest bearing in foreign branches  | 683,792                                 | 967,497              |
| Total deposits  | 3,388,963                               | 3,066,377            |
| Accrued interest payable  | 5,508                                   | 5,630                |
| Other liabilities   | 18,931                                  | 23,047               |
| Federal funds purchased   | 240,405                                 | 344,813              |
| Repurchase agreements   | 42,032                                  | 7,148                |
| Other borrowings  | 552,588                                 | 431,890              |
| Trust preferred subordinated debentures   | 113,406                                 | 113,406              |
| Total liabilities   | 4,361,833                               | 3,992,311            |
| Stockholders equity:  |   |                      |
| Common stock, \$.01 par value:  |   |                      |
| Authorized shares - 100,000,000   |   |                      |
| Issued shares -30,844,202 and 26,389,548 at September 30, 2008 and<br>December 31, 2007, respectively | 308                                     | 264                  |
| Additional paid-in capital  | 253,599                                 | 190,175              |

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|   |              |              |
|---|--------------|--------------|
| Retained earnings   | 126,464      | 105,585      |
| Treasury stock (shares at cost: 84,691 at September 30, 2008 and December 31, 2007) | (581)        | (581)        |
| Deferred compensation   | 573          | 573          |
| Accumulated other comprehensive income (loss), net of taxes                         | 495          | (878)        |
| Total stockholders' equity  | 380,858      | 295,138      |
| Total liabilities and stockholders' equity  | \$ 4,742,691 | \$ 4,287,449 |

See accompanying notes to consolidated financial statements.

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**Table of Contents****TEXAS CAPITAL BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(In thousands except share data)

|  | Common Stock |        | Additional         | Retained   | Treasury Stock |          | Deferred     | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|--------------|--------|--------------------|------------|----------------|----------|--------------|---|------------|
|  | Shares       | Amount | Paid-in<br>Capital | Earnings   | Shares         | Amount   | Compensation | (Loss)  |            |
| Balance at<br>December 31,<br>2006   | 26,065,124   | \$ 261 | \$ 182,321         | \$ 76,163  | (84,274)       | \$ (573) | \$ 573       | \$ (5,230)                                      | \$ 253,515 |
| Comprehensive<br>income:   |              |        |                    |            |                |          |              |   |            |
| Net income<br>(unaudited)  |              |        |                    | 24,069     |                |          |              |   | 24,069     |
| Change in<br>unrealized loss on<br>available-for-sale<br>securities, net of<br>taxes of \$370<br>(unaudited) |              |        |                    |            |                |          |              | 687   | 687        |
| Total<br>comprehensive<br>income<br>(unaudited)  |              |        |                    |            |                |          |              |   | 24,756     |
| Tax benefit related<br>to exercise of<br>stock options<br>(unaudited)  |              |        | 704                |            |                |          |              |   | 704        |
| Stock-based<br>compensation<br>expense<br>recognized in<br>earnings<br>(unaudited)                           |              |        | 3,809              |            |                |          |              |   | 3,809      |
| Issuance of stock<br>related to<br>stock-based<br>awards<br>(unaudited)                                      | 178,025      | 2      | 1,431              |            |                |          |              |   | 1,433      |
| Purchase of<br>treasury stock<br>(unaudited)   |              |        |                    |            | (417)          | (8)      |              |   | (8)        |
| Balance at<br>September 30,  | 26,243,149   | \$ 263 | \$ 188,265         | \$ 100,232 | (84,691)       | \$ (581) | \$ 573       | \$ (4,543)                                      | \$ 284,209 |



2007 (unaudited)

|  |            |        |            |            |          |          |        |          |            |
|--|------------|--------|------------|------------|----------|----------|--------|----------|------------|
| Balance at<br>December 31,<br>2007   | 26,389,548 | \$ 264 | \$ 190,175 | \$ 105,585 | (84,691) | \$ (581) | \$ 573 | \$ (878) | \$ 295,138 |
| Comprehensive<br>income:   |            |        |            |            |          |          |        |          |            |
| Net income<br>(unaudited)  |            |        |            | 20,879     |          |          |        |          | 20,879     |
| Change in<br>unrealized loss on<br>available-for-sale<br>securities, net of<br>tax benefit of \$739<br>(unaudited) |            |        |            |            |          |          | 1,373  |          | 1,373      |
| Total<br>comprehensive<br>income<br>(unaudited)  |            |        |            |            |          |          |        |          | 22,252     |
| Tax benefit related<br>to exercise of<br>stock options<br>(unaudited)  |            |        | 1,357      |            |          |          |        |          | 1,357      |
| Stock-based<br>compensation<br>expense<br>recognized in<br>earnings<br>(unaudited)                                 |            |        | 3,839      |            |          |          |        |          | 3,839      |
| Issuance of stock<br>related to<br>stock-based<br>awards<br>(unaudited)  | 454,654    | 4      | 3,265      |            |          |          |        |          | 3,269      |
| Issuance of<br>common stock<br>(unaudited)   | 4,000,000  | 40     | 54,963     |            |          |          |        |          | 55,003     |
| Balance at<br>September 30,<br>2008 (unaudited)  | 30,844,202 | \$ 308 | \$ 253,599 | \$ 126,464 | (84,691) | \$ (581) | \$ 573 | \$ 495   | \$ 380,858 |

See accompanying notes to consolidated financial statements.

**Table of Contents****TEXAS CAPITAL BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED**

(In thousands)

|   | Nine months ended<br>September 30 |             |
|---|-----------------------------------|-------------|
|   | 2008                              | 2007        |
| <b>Operating activities</b>   |                                   |             |
| Net income from continuing operations   | \$ 21,395                         | \$ 24,815   |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                                   |             |
| Provision for loan losses   | 15,750                            | 4,700       |
| Depreciation and amortization   | 5,762                             | 5,436       |
| Amortization and accretion on securities  | 222                               | 247         |
| Bank owned life insurance (BOLI) income   | (925)                             | (887)       |
| Stock-based compensation expense  | 3,839                             | 3,809       |
| Tax benefit from stock option exercises   | 1,357                             | 704         |
| Excess tax benefits from stock-based compensation arrangements                              | (3,878)                           | (2,010)     |
| Originations of loans held for sale   | (5,125,817)                       | (3,080,942) |
| Proceeds from sales of loans held for sale  | 4,956,982                         | 3,151,025   |
| Changes in operating assets and liabilities:  |                                   |             |
| Accrued interest receivable and other assets  | (17,949)                          | (38)        |
| Accrued interest payable and other liabilities  | (4,977)                           | (1,587)     |
| Net cash (used in) provided by operating activities of continuing operations                | (148,239)                         | 105,272     |
| Net cash (used in) provided by operating activities of discontinued operations              | (509)                             | 20,089      |
| Net cash (used in) provided by operating activities   | (148,748)                         | 125,361     |
| <b>Investing activities</b>   |                                   |             |
| Purchases of available-for-sale securities  | (4,372)                           | (24,423)    |
| Maturities and calls of available-for-sale securities                                       | 15,935                            | 19,438      |
| Principal payments received on securities   | 65,301                            | 61,399      |
| Net increase in loans held for investment   | (385,058)                         | (561,706)   |
| Purchase of premises and equipment, net   | (643)                             | (14,824)    |
| Net cash used in investing activities of continuing operations                              | (308,837)                         | (520,116)   |
| <b>Financing activities</b>   |                                   |             |
| Net increase in deposits  | 322,586                           | 226,377     |
| Proceeds from issuance of stock related to stock-based awards                               | 3,269                             | 1,433       |
| Proceeds from issuance of common stock  | 55,003                            |             |
| Net increase in other borrowings  | 155,582                           | 96,162      |
| Excess tax benefits from stock-based compensation arrangements                              | 3,878                             | 2,010       |
| Net increase (decrease) in federal funds purchased  | (104,408)                         | 50,789      |
| Purchase of treasury stock  |                                   | (8)         |

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|  |           |            |
|--|-----------|------------|
| Net cash provided by financing activities of continuing operations | 435,910   | 376,763    |
| Net decrease in cash and cash equivalents                          | (21,675)  | (17,992)   |
| Cash and cash equivalents at beginning of period                   | 89,463    | 93,716     |
| Cash and cash equivalents at end of period                         | \$ 67,788 | \$ 75,724  |
| Supplemental disclosures of cash flow information:                 |           |            |
| Cash paid during the period for interest                           | \$ 77,154 | \$ 111,522 |
| Cash paid during the period for income taxes                       | 18,319    | 13,302     |
| Non-cash transactions:   |           |            |
| Transfers from loans/leases to other real estate owned             | 3,120     |            |
| Transfers from loans/leases to premises and equipment              |           | 1,084      |
| See accompanying notes to consolidated financial statements.       |           |            |

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**TEXAS CAPITAL BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED**

**(1) OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

Texas Capital Bancshares, Inc., a Delaware bank holding company, was incorporated in November 1996 and commenced operations in March 1998. The consolidated financial statements of the Company include the accounts of Texas Capital Bancshares, Inc. and its wholly owned subsidiary, Texas Capital Bank, National Association (the Bank ). The Bank currently provides commercial banking services to its customers in Texas and concentrates on middle market commercial and high net worth customers.

**Basis of Presentation**

The accounting and reporting policies of Texas Capital Bancshares, Inc. conform to accounting principles generally accepted in the United States and to generally accepted practices within the banking industry. Our consolidated financial statements include the accounts of Texas Capital Bancshares, Inc. and its subsidiary, the Bank. Certain prior period balances have been reclassified to conform with the current period presentation.

The consolidated interim financial statements have been prepared without audit. Certain information and footnote disclosures presented in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, the interim financial statements include all normal and recurring adjustments and the disclosures made are adequate to make interim financial information not misleading. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission ( SEC ). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with our consolidated financial statements, and notes thereto, for the year ended December 31, 2007, included in our Annual Report on Form 10-K filed with the SEC on February 26, 2008 (the 2007 Form 10-K ). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. The allowance for possible loan losses, the fair value of stock-based compensation awards, the fair values of financial instruments and the status of contingencies are particularly susceptible to significant change in the near term.

**Accumulated Other Comprehensive Income (Loss)**

Unrealized gains or losses on our available-for-sale securities (after applicable income tax expense or benefit) are included in accumulated other comprehensive income (loss). Accumulated comprehensive income (loss) for the nine months ended September 30, 2008 and 2007 is reported in the accompanying consolidated statements of changes in shareholders' equity. We had comprehensive income of \$9.0 million for the three months ended September 30, 2008 and comprehensive income of \$12.2 million for the three months ended September 30, 2007. Comprehensive income during the three months ended September 30, 2008 included a net after-tax gain of \$1.7 million, and comprehensive income during the three months ended September 30, 2007 included a net after-tax gain of \$3.9 million due to changes in the net unrealized gains/losses on securities available-for-sale.

**Fair Values of Financial Instruments**

Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit

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risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on- and off-balance sheet financial instruments do not include the value of anticipated future business or the value of assets and liabilities not considered financial instruments. Effective January 1, 2008, we adopted Statement of Financial Accounting Standard No. 157, Fair Value Measurements ( SFAS 157 ). The adoption of SFAS 157 did not have an impact on our financial statements except for the expanded disclosures noted in Note 10 Fair Value Disclosures.

**(2) EARNINGS PER SHARE**

The following table presents the computation of basic and diluted earnings per share (in thousands except per share data):

|  | Three months ended<br>September 30 |            | Nine months ended<br>September 30 |            |
|--|------------------------------------|------------|-----------------------------------|------------|
|  | 2008                               | 2007       | 2008                              | 2007       |
| Numerator:   |                                    |            |                                   |            |
| Net income from continuing operations  | \$ 7,565                           | \$ 8,844   | \$ 21,395                         | \$ 24,815  |
| Loss from discontinued operations  | (252)                              | (602)      | (516)                             | (746)      |
| Net income   | \$ 7,313                           | \$ 8,242   | \$ 20,879                         | \$ 24,069  |
| Denominator:   |                                    |            |                                   |            |
| Denominator for basic earnings per<br>share-weighted average shares  | 27,725,573                         | 26,212,494 | 26,968,720                        | 26,148,778 |
| Effect of employee stock options <sup>(1)</sup>  | 67,365                             | 554,294    | 76,087                            | 492,011    |
| Denominator for dilutive earnings per<br>share-adjusted weighted average shares<br>and assumed conversions | 27,792,938                         | 26,766,788 | 27,044,807                        | 26,640,789 |
| Basic earnings per share from<br>continuing operations   |                                    |            |                                   |            |
|  | \$ .27                             | \$ .34     | \$ .79                            | \$ .95     |
| Basic earnings per share from<br>discontinued operations   | (.01)                              | (.03)      | (.02)                             | (.03)      |
| Basic earnings per share   | \$ .26                             | \$ .31     | \$ .77                            | \$ .92     |
| Diluted earnings per share from<br>continuing operations   |                                    |            |                                   |            |
|  | \$ .27                             | \$ .33     | \$ .79                            | \$ .93     |
| Diluted earnings per share from<br>discontinued operations   | (.01)                              | (.02)      | (.02)                             | (.03)      |
| Diluted earnings per share   | \$ .26                             | \$ .31     | \$ .77                            | \$ .90     |

(1)

Stock options outstanding of 1,630,781 at September 30, 2008 and 817,170 at September 30, 2007 have not been included in diluted earnings per share because to do so would have been anti-dilutive for the periods presented. Stock options are anti-dilutive when the exercise price is higher than the average market price of our common stock.

**(3) SECURITIES**

Securities are identified as either held-to-maturity or available-for-sale based upon various factors, including asset/liability management strategies, liquidity and profitability objectives, and regulatory requirements.

Held-to-maturity securities are carried at cost, adjusted for amortization of premiums or accretion of discounts.

Available-for-sale securities are securities that may be sold prior to maturity based upon asset/liability management decisions. Securities identified as available-for-sale are carried at fair value. Unrealized gains or losses on available-for-sale securities are recorded as accumulated other comprehensive income in stockholders' equity, net of taxes. Amortization of premiums or accretion of discounts on mortgage-backed securities is periodically adjusted for estimated prepayments.

Our net unrealized loss on the available-for-sale securities portfolio value increased from a loss of \$1.4 million, which represented 0.29% of the amortized cost at December 31, 2007, to a gain of \$761,000, which represented 0.21% of the amortized cost at September 30, 2008.

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The following table discloses, as of September 30, 2008, our investment securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 or more months (in thousands):

|                            | Less Than 12 Months |                 | 12 Months or Longer |                 | Total      |                 |
|----------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
|                            | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasuries            | \$                  | \$              | \$                  | \$              | \$         | \$              |
| Mortgage-backed securities | 135,489             | (1,180)         | 3,047               | (65)            | 138,536    | (1,245)         |
| Municipals                 | 23,218              | (584)           |                     |                 | 23,218     | (584)           |
|                            | \$ 158,707          | \$(1,764)       | \$ 3,047            | \$(65)          | \$ 161,754 | \$(1,829)       |

At September 30, 2008, the number of investment positions in this unrealized loss position totals 82. We do not believe these unrealized losses are other than temporary as (1) we have the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value, and (2) it is not probable that we will be unable to collect the amounts contractually due. The unrealized losses noted are interest rate related. We have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities.

**(4) LOANS AND ALLOWANCE FOR LOAN LOSSES**

At September 30, 2008 and December 31, 2007, loans were as follows (in thousands):

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| Commercial  | \$2,156,950           | \$2,035,049          |
| Construction                                      | 633,121               | 573,459              |
| Real estate                                       | 956,280               | 773,970              |
| Consumer  | 35,540                | 28,334               |
| Leases  | 80,994                | 74,523               |
| Gross loans held for investment                   | 3,862,885             | 3,485,335            |
| Deferred income (net of direct origination costs) | (22,713)              | (22,727)             |
| Allowance for loan losses                         | (40,998)              | (32,821)             |
| Total loans held for investment, net              | \$3,799,174           | \$3,429,787          |

We continue to lend primarily in Texas. As of September 30, 2008, a substantial majority of the principal amount of the loans in our portfolio was to businesses and individuals in Texas. This geographic concentration subjects the loan portfolio to the general economic conditions within this area. We originate substantially all of the loans in our portfolio, except in certain instances we have purchased selected loan participations and interests in certain syndicated credits and United States Department of Agriculture ( USDA ) government guaranteed loans.

**Table of Contents****Non-Performing Assets**

Non-performing loans and leases at September 30, 2008, December 31, 2007 and September 30, 2007 are summarized as follows (in thousands):

|   | September<br>30,<br>2008 | December<br>31,<br>2007 | September<br>30,<br>2007 |
|---|--------------------------|-------------------------|--------------------------|
| Non-accrual loans: <sup>(1)</sup> <sup>(3)</sup> <sup>(4)</sup>       |                          |                         |                          |
| Commercial  | \$ 1,525                 | \$ 14,693               | \$ 2,601                 |
| Construction  | 23,349                   | 4,147                   | 4,952                    |
| Real estate   | 21,121                   | 2,453                   | 1,118                    |
| Consumer  | 119                      | 90                      | 12                       |
| Equipment leases  | 465                      | 2                       | 7                        |
| <b>Total non-accrual loans</b>  | <b>46,579</b>            | <b>21,385</b>           | <b>8,690</b>             |
| Loans past due (90 days) <sup>(2)</sup> <sup>(3)</sup> <sup>(4)</sup> | 2,970                    | 4,147                   | 4,356                    |
| Other repossessed assets:   |                          |                         |                          |
| Other real estate owned <sup>(3)</sup>                                | 5,792                    | 2,671                   | 501                      |
| Other repossessed assets  | 25                       | 45                      | 89                       |
| <b>Total other repossessed assets</b>                                 | <b>5,817</b>             | <b>2,716</b>            | <b>590</b>               |
| <b>Total non-performing assets</b>                                    | <b>\$55,366</b>          | <b>\$28,248</b>         | <b>\$ 13,636</b>         |

(1) The accrual of interest on loans is discontinued when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. When a loan is placed on non-accrual status, all previously accrued and unpaid interest is reversed.



Interest income is subsequently recognized on a cash basis as long as the remaining unpaid principal amount of the loan is deemed to be fully collectible. If collectability is questionable, then cash payments are applied to principal.

(2) At September 30, 2008, \$2.1 million of the loans past due 90 days and still accruing are premium finance loans. These loans are generally secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take 180 days or longer from the cancellation date.

(3) At September 30, 2008, non-performing

assets include  
\$4.4 million of  
mortgage  
warehouse loans  
that were  
transferred to  
our loans held  
for investment  
at lower of cost  
or market, and  
some  
subsequently  
moved to other  
real estate  
owned.

At September 30, 2008, our total non-accrual loans were \$46.6 million. Of these \$23.3 million were characterized as construction loans. This included an \$8.8 million residential real estate development loan secured by approximately 80 single family residences and fully-developed residential lots. The loan was subsequently foreclosed in October 2008 with the collateral properties transferred to ORE net of a \$1 million charge-off that was fully reserved and included in the allowance for loan losses as of September 30, 2008. Also included in the construction category was an \$8.9 million residential real estate development loan secured by fully-developed residential lots and unimproved land. We believe specific reserves allocated to this credit as of September 30, 2008 are adequate based upon our assessment of impairment which was based upon the value of our collateral. \$21.1 million of our non accrual loans are characterized as real estate loans. This includes a \$9.4 million loan secured by commercial property on which the bank earlier committed to finance the construction of a shopping center. A \$3.3 million loan is secured by an office building; and, a \$1.7 million loan is secured by a commercial lot. Real estate loans also include \$3.6 million of single family mortgages that were originated in our mortgage warehouse operation. Each of these real estate loans were reviewed for impairment and specific reserves were allocated as necessary and included in the allowance for loan losses as of September 30, 2008 to cover any probable loss.

**Table of Contents****Allowance for Loan Losses**

Activity in the allowance for loan losses was as follows (in thousands):

|  | Three months ended |          | Nine months ended |          |
|--|--------------------|----------|-------------------|----------|
|  | September 30,      |          | September 30,     |          |
|  | 2008               | 2007     | 2008              | 2007     |
| Balance at the beginning of the period | \$38,460           | \$24,062 | \$32,821          | \$21,003 |
| Provision for loan losses              | 4,000              | 2,000    | 15,750            | 4,700    |
| Net charge-offs:                       |                    |          |                   |          |
| Loans charged-off                      | 1,541              | 155      | 8,408             | 455      |
| Recoveries                             | 79                 | 96       | 835               | 755      |
| Net charge-offs (recoveries)           | 1,462              | 59       | 7,573             | (300)    |
| Balance at the end of the period       | \$40,998           | \$26,003 | \$40,998          | \$26,003 |

**(5) PREMISES AND EQUIPMENT**

Premises and equipment are stated at cost, less accumulated depreciation, computed by the straight-line method based on the estimated useful lives of the assets, which range from three to ten years. Gains or losses on disposals of premises and equipment are included in results of operations.

Premises and equipment at September 30, 2008, December 31, 2007 and September 30, 2007 are summarized as follows (in thousands):

|                                   | September<br>30,<br>2008 | December 31,<br>2007 | September<br>30,<br>2007 |
|-----------------------------------|--------------------------|----------------------|--------------------------|
| Premises                          | \$ 6,519                 | \$ 6,178             | \$ 6,089                 |
| Furniture and equipment           | 14,715                   | 14,242               | 12,975                   |
| Rental equipment <sup>(1)</sup>   | 31,443                   | 33,105               | 42,688                   |
|                                   | 52,677                   | 53,525               | 61,752                   |
| Accumulated depreciation          | (25,994)                 | (21,841)             | (19,528)                 |
| Total premises and equipment, net | \$ 26,683                | \$ 31,684            | \$ 42,224                |

(1) These assets represent the assets related to operating leases where the Bank is the lessor.

**(6) FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit which involve varying degrees of credit risk in excess of the amount recognized in the consolidated balance sheets. Our exposure to credit loss in the event of non-performance by the other party to the financial

instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the borrower.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit-worthiness on a case-by-case basis.

Standby letters of credit are conditional commitments we issue to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

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|   |                       |
|---|-----------------------|
| (In thousands)  | September 30,<br>2008 |
| Financial instruments whose contract amounts represent credit risk: |                       |
| Commitments to extend credit  | \$1,404,714           |
| Standby letters of credit   | 71,583                |

**(7) REGULATORY MATTERS**

The Company and the Bank are subject to various banking laws and regulations related to compliance and capital requirements administered by the federal banking agencies. Regulatory focus on Bank Secrecy Act and Patriot Act compliance remains a high priority. Failure to comply with applicable laws and regulations or to meet minimum capital requirements can result in certain mandatory and discretionary actions by regulators that, if undertaken, could have a direct and material effect on the Company's and the Bank's business activities, results of operations and financial condition. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with relevant laws or regulations, could have serious legal, reputational, and financial consequences for the institution. Because of the significance of regulatory emphasis on these requirements, the Company and the Bank will continue to expend significant staffing, technology and financial resources to maintain programs designed to ensure compliance with applicable laws and regulations and an effective audit function for testing our compliance with the Bank Secrecy Act on an ongoing basis.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of September 30, 2008, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

Financial institutions are categorized as well capitalized or adequately capitalized, based on minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table below. As shown below, the Bank's capital ratios exceed the regulatory definition of well capitalized as of September 30, 2008 and 2007. As of June 30, 2008, the most recent notification from the OCC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There have been no conditions or events since the notification that management believes have changed the Bank's category. Based upon the information in its most recently filed call report, the Bank continues to meet the capital ratios necessary to be well capitalized under the regulatory framework for prompt corrective action. Based on the bank capital ratio information in our most recently filed call report and the consolidated capital ratios as shown in the table below, we continue to meet the capital ratios necessary to be well capitalized under the regulatory framework for prompt corrective action.

|                     | September 30, |        |
|---------------------|---------------|--------|
|                     | 2008          | 2007   |
| Risk-based capital: |               |        |
| Tier 1 capital      | 10.54%        | 9.59%  |
| Total capital       | 11.44%        | 10.67% |
| Leverage            | 10.45%        | 9.37%  |

**(8) STOCK-BASED COMPENSATION**

The fair value of our stock option and stock appreciation right (SAR) grants are estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price

volatility. Because our employee stock options have characteristics significantly

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different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide the best single measure of the fair value of its employee stock options.

As a result of applying the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment (Revised 2004) ( SFAS 123R ) during the three and nine months ended September 30, 2008, we recognized stock-based compensation expense of \$1.3 million, or \$834,000 net of tax, and \$3.8 million, or \$2.5 million, net of tax. The amount for the three months ended September 30, 2008 is comprised of \$266,000 related to unvested options issued prior to the adoption of SFAS 123R, \$427,000 related to SARs issued in 2006, 2007 and 2008, and \$579,000 related to restricted stock units ( RSUs ) issued in 2006, 2007 and 2008. The amount for the nine months ended September 30, 2008 is comprised of \$903,000 related to unvested options issued prior to the adoption of SFAS 123R, \$1.3 million related to SARs issued during 2006, 2007 and 2008, and \$1.7 million related to RSUs issued in 2006, 2007 and 2008. Unrecognized stock-based compensation expense related to unvested options issued prior to adoption of SFAS 123R is \$1.1 million, pre-tax. At September 30, 2008, the weighted average period over which this unrecognized expense is expected to be recognized was 1.2 years. Unrecognized stock-based compensation expense related to grants during 2006, 2007 and 2008 is \$12.3 million. At September 30, 2008, the weighted average period over which this unrecognized expense is expected to be recognized was 2.1 years.

**(9) DISCONTINUED OPERATIONS**

On March 30, 2007, we completed the sale of our TexCap Insurance Services ( TexCap ) subsidiary; the sale was, accordingly, reported as a discontinued operation. Historical operating results of TexCap and the net after-tax gain of \$1.09 million from the sale, are reflected as discontinued operations in the financial statements with income from discontinued operations of \$704,000, net of taxes for the quarter ended March 31, 2007.

Subsequent to the end of the first quarter of 2007, we and the purchaser of our residential mortgage loan division (RML) agreed to terminate and settle the contractual arrangements related to the sale of the division, which had been completed as of the end of the third quarter of 2006. Historical operating results of RML are reflected as discontinued operations in the financial statements.

During the three months ended September 30, 2008 and September 30, 2007, the loss from discontinued operations was \$252,000 and \$602,000, net of taxes, respectively. For the nine months ended September 30, 2008 and 2007, the loss from discontinued operations was \$516,000 and \$746,000, net of taxes, respectively. The 2008 losses are primarily related to continuing legal and salary expenses incurred in dealing with the remaining loans and requests from investors related to the repurchase of previously sold loans. We still have approximately \$648,000 in loans held for sale from discontinued operations that are carried at the estimated market value at quarter-end, which is less than the original cost. We plan to sell these loans, but timing and price to be realized cannot be determined at this time due to market conditions. In addition, we continue to address requests from investors related to repurchasing loans previously sold. While the balances as of September 30, 2008 include a liability for exposure to additional contingencies, including risk of having to repurchase loans previously sold, we recognize that market conditions may result in additional exposure to loss and the extension of time necessary to complete the discontinued mortgage operation.

**(10) FAIR VALUE DISCLOSURES**

Effective January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal market for the asset or liability in an orderly transaction between market participants on the measurement date. The adoption of SFAS 157 did not have an impact on our financial statements except for the expanded disclosures noted below.

We determine the fair market values of our financial instruments based on the fair value hierarchy. The standard describes three levels of inputs that may be used to measure fair value as provided below.

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets include US Treasuries that are highly liquid and are actively traded in over-the-counter markets.





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Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets include US government and agency mortgage-backed debt securities, corporate securities, municipal bonds, and Community Reinvestment Act funds.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair values requires significant management judgment or estimation. This category generally includes certain mortgage loans that are transferred from loans held for sale to loans held for investment at a lower of cost or fair value, as well as other real estate owned (OREO) and impaired loans where collateral values have been used as the basis of calculating impairment value.

Assets and liabilities measured at fair value at September 30, 2008 are as follows (in thousands):

|   | Fair Value Measurements Using |            |           |
|---|-------------------------------|------------|-----------|
|   | Level 1                       | Level 2    | Level 3   |
| Assets:   |                               |            |           |
| Available for sale securities: <sup>(1)</sup>     |                               |            |           |
| Treasuries  | \$ 1,799                      | \$         | \$        |
| Mortgage-backed securities                        |                               | 304,803    |           |
| Corporate securities                              |                               | 5,149      |           |
| Municipals  |                               | 46,000     |           |
| Other   |                               | 7,394      |           |
| Loans <sup>(2) (4)</sup>                          |                               |            | 56,659    |
| Other real estate owned (OREO) <sup>(3) (4)</sup> |                               |            | 5,792     |
| Total assets                                      | \$ 1,799                      | \$ 363,346 | \$ 62,451 |

(1) Securities are measured at fair value on a recurring basis, generally monthly.

(2) Includes certain mortgage loans that have been transferred to loans held for investment from loans held for sale at the lower of cost or market. Also, includes

impaired loans that have been measured for impairment at the fair value of the loan's collateral.

(3) Other real estate owned is transferred from loans to OREO at the lower of cost or market.

(4) Fair value of loans and OREO is measured on a nonrecurring basis.

### **Level 3 Valuations**

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. Currently, we measure fair value for certain loans and OREO on a nonrecurring basis as described below.

*Loans* Certain mortgage loans that are transferred from loans held for sale to loans held for investment are valued based on third party broker pricing. As the dollar amount and number of loans being valued is very small, a comprehensive market analysis is not obtained or considered necessary. Instead, we conduct a general polling of one or more mortgage brokers for indications of general market prices for the types of mortgage loans being valued, and we consider values based on recent experience in selling loans of like terms and comparable quality. The total also includes impaired loans that have been measured for impairment at the fair value of the loan's collateral based on a third party real estate appraisal.

*Other real estate owned* Property is fair valued at the time of foreclosure and transfer to OREO from loans. Generally, we have third party real estate appraisals that are used to determine fair value.

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**(11) NEW ACCOUNTING PRONOUNCEMENTS**

*Statement of Financial Accounting Standard No. 157, Fair Value Measurements* ( SFAS 157 ) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for the Bank on January 1, 2008 and did not have a significant impact on our financial statements. See Note 1 and Note 10 for additional discussion.

*SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ) permits entities to choose to measure eligible items at fair value at specified election dates. The Bank has not elected the fair value option under SFAS 159 for any existing assets or liabilities.

*SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB Statement No. 5.* ( SFAS 160 ) amends Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, SFAS 160 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 is effective for the Bank on January 1, 2009 and is not expected to have a significant impact on our financial statements.

**Table of Contents****QUARTERLY FINANCIAL SUMMARY UNAUDITED**

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

|   | For the three months ended<br>September 30, 2008 |                                    |                | For the three months ended<br>September 30, 2007 |                                    |                |
|---|--|------------------------------------|----------------|--|------------------------------------|----------------|
|   | Average<br>Balance                               | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate | Average<br>Balance                               | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate |
| <b>Assets</b>                                     |  |                                    |                |  |                                    |                |
| Securities taxable                                | \$ 325,317                                       | \$ 3,852                           | 4.71%          | \$ 416,092                                       | \$ 4,959                           | 4.73%          |
| Securities non-taxable <sup>(2)</sup>             | 47,271   | 660                                | 5.55%          | 48,173   | 671                                | 5.53%          |
| Federal funds sold                                | 8,001  | 40                                 | 1.99%          | 885  | 12                                 | 5.38%          |
| Deposits in other banks                           | 2,554  | 10                                 | 1.56%          | 1,217  | 14                                 | 4.56%          |
| Loans held for sale from<br>continuing operations | 288,103  | 4,137                              | 5.78%          | 150,031  | 2,618                              | 6.92%          |
| Loans   | 3,781,289  | 53,772                             | 5.66%          | 3,195,480  | 68,101                             | 8.46%          |
| Less reserve for loan<br>losses                   | 38,180   |                                    |                | 24,065   |                                    |                |
| Loans, net of reserve                             | 4,031,212  | 57,909                             | 5.71%          | 3,321,446  | 70,719                             | 8.45%          |
| Total earning assets                              | 4,414,355  | 62,471                             | 5.63%          | 3,787,813  | 76,375                             | 8.00%          |
| Cash and other assets                             | 201,589  |                                    |                | 204,859  |                                    |                |
| Total assets                                      | \$ 4,615,944                                     |                                    |                | \$ 3,992,672                                     |                                    |                |
| <b>Liabilities and<br/>Stockholders Equity</b>    |  |                                    |                |  |                                    |                |
| Transaction deposits                              | \$ 103,905                                       | \$ 122                             | .47%           | \$ 95,870  | \$ 239                             | 0.99%          |
| Savings deposits                                  | 778,956  | 3,371                              | 1.72%          | 848,760  | 9,393                              | 4.39%          |
| Time deposits                                     | 1,275,798  | 10,524                             | 3.28%          | 760,511  | 9,877                              | 5.15%          |
| Deposits in foreign<br>branches                   | 720,211  | 4,321                              | 2.39%          | 1,037,813  | 13,181                             | 5.04%          |
| Total interest bearing<br>deposits                | 2,878,870  | 18,338                             | 2.53%          | 2,742,954  | 32,690                             | 4.73%          |
| Other borrowings                                  | 709,157  | 4,150                              | 2.33%          | 368,824  | 4,831                              | 5.20%          |
| Trust preferred<br>subordinated debentures        | 113,406  | 1,486                              | 5.21%          | 113,406  | 2,088                              | 7.30%          |
| Total interest bearing<br>liabilities             | 3,701,433  | 23,974                             | 2.58%          | 3,225,184  | 39,609                             | 4.87%          |
| Demand deposits                                   | 567,914  |                                    |                | 469,610  |                                    |                |
| Other liabilities                                 | 16,452   |                                    |                | 22,173   |                                    |                |
| Stockholders equity                               | 330,145  |                                    |                | 275,705  |                                    |                |
|   | \$ 4,615,944                                     |                                    |                | \$ 3,992,672                                     |                                    |                |

Total liabilities and  
stockholders equity

|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 38,497 | \$ 36,766 |
| Net interest margin | 3.47%     | 3.85%     |
| Net interest spread | 3.05%     | 3.13%     |

(1) The loan averages include loans on which the accrual of interest has been discontinued and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

Additional information  
from discontinued  
operations:

|                                  |        |          |
|----------------------------------|--------|----------|
| Loans held for sale              | \$ 686 | \$ 1,259 |
| Borrowed funds                   | 686    | 1,259    |
| Net interest income              | \$ 15  | \$ 5     |
| Net interest margin consolidated | 3.47%  | 3.85%    |

**Table of Contents****QUARTERLY FINANCIAL SUMMARY UNAUDITED**

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

|   | For the nine months ended<br>September 30, 2008 |                                    |                | For the nine months ended<br>September 30, 2007 |                                    |                |
|---|---|------------------------------------|----------------|---|------------------------------------|----------------|
|   | Average<br>Balance                              | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate | Average<br>Balance                              | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate |
| <b>Assets</b>                                     |   |                                    |                |   |                                    |                |
| Securities taxable                                | \$ 353,902                                      | \$ 12,390                          | 4.68%          | \$ 435,999                                      | \$ 15,481                          | 4.75%          |
| Securities non-taxable <sup>(2)</sup>             | 47,846  | 2,002                              | 5.59%          | 48,336  | 2,005                              | 5.55%          |
| Federal funds sold                                | 7,948   | 141                                | 2.37%          | 692   | 27                                 | 5.22%          |
| Deposits in other banks                           | 1,639   | 30                                 | 2.44%          | 1,193   | 44                                 | 4.93%          |
| Loans held for sale from<br>continuing operations | 235,460   | 10,401                             | 5.90%          | 166,113   | 8,849                              | 7.12%          |
| Loans   | 3,621,410                                       | 165,794                            | 6.12%          | 2,977,625                                       | 189,570                            | 8.51%          |
| Less reserve for loan<br>losses                   | 34,972  |                                    |                | 22,578  |                                    |                |
| Loans, net of reserve                             | 3,821,898                                       | 176,195                            | 6.16%          | 3,121,160                                       | 198,419                            | 8.50%          |
| Total earning assets                              | 4,233,233                                       | 190,758                            | 6.02%          | 3,607,380                                       | 215,976                            | 8.00%          |
| Cash and other assets                             | 202,706   |                                    |                | 222,620   |                                    |                |
| Total assets                                      | \$ 4,435,939                                    |                                    |                | \$ 3,830,000                                    |                                    |                |
| <b>Liabilities and<br/>Stockholders Equity</b>    |   |                                    |                |   |                                    |                |
| Transaction deposits                              | \$ 107,932                                      | \$ 396                             | .49%           | \$ 98,281                                       | \$ 757                             | 1.03%          |
| Savings deposits                                  | 803,269   | 12,052                             | 2.00%          | 821,751   | 27,360                             | 4.45%          |
| Time deposits                                     | 979,084   | 26,744                             | 3.65%          | 728,446   | 28,049                             | 5.15%          |
| Deposits in foreign<br>branches                   | 810,472   | 17,585                             | 2.90%          | 973,692   | 37,145                             | 5.10%          |
| Total interest bearing<br>deposits                | 2,700,757                                       | 56,777                             | 2.81%          | 2,622,170                                       | 93,311                             | 4.76%          |
| Other borrowings                                  | 770,704   | 15,418                             | 2.67%          | 349,300   | 13,544                             | 5.18%          |
| Trust preferred<br>subordinated debentures        | 113,406   | 4,837                              | 5.70%          | 113,406   | 6,198                              | 7.31%          |
| Total interest bearing<br>liabilities             | 3,584,867                                       | 77,032                             | 2.87%          | 3,084,876                                       | 113,053                            | 4.90%          |
| Demand deposits                                   | 517,033   |                                    |                | 455,704   |                                    |                |
| Other liabilities                                 | 17,708  |                                    |                | 23,755  |                                    |                |
| Stockholders equity                               | 316,331   |                                    |                | 265,665   |                                    |                |
|   | \$ 4,435,939                                    |                                    |                | \$ 3,830,000                                    |                                    |                |

Total liabilities and  
stockholders equity

|                     |            |       |            |
|---------------------|------------|-------|------------|
| Net interest income | \$ 113,726 |       | \$ 102,923 |
| Net interest margin |            | 3.59% | 3.81%      |
| Net interest spread |            | 3.15% | 3.10%      |

(1) The loan averages include loans on which the accrual of interest has been discontinued and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

Additional information  
from discontinued  
operations:

|                                  |        |       |          |
|----------------------------------|--------|-------|----------|
| Loans held for sale              | \$ 716 |       | \$ 5,788 |
| Borrowed funds                   | 716    |       | 5,788    |
| Net interest income              | \$ 40  |       | \$ 166   |
| Net interest margin consolidated |        | 3.59% | 3.81%    |

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

***Forward Looking Statements***

Statements and financial analysis contained in this document that are not historical facts are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements describe our future plans, strategies and expectations and are based on certain assumptions. As a result, these forward looking statements involve substantial risks and uncertainties, many of which are beyond our control. The important factors that could cause actual results to differ materially from the forward looking statements include the following:

- (1) Changes in interest rates and the relationship between rate indices, including LIBOR and Fed Funds
- (2) Changes in the levels of loan prepayments, which could affect the value of our loans or investment securities
- (3) Changes in general economic and business conditions in areas or markets where we compete
- (4) Competition from banks and other financial institutions for loans and customer deposits
- (5) The failure of assumptions underlying the establishment of and provisions made to the allowance for credit losses
- (6) The loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels
- (7) Changes in government regulations

We have no obligation to update or revise any forward looking statements as a result of new information or future events. In light of these assumptions, risks and uncertainties, the events discussed in any forward looking statements in this quarterly report might not occur.

***Results of Operations***

Except as otherwise noted, all amounts and disclosures throughout this document reflect continuing operations. See Part I, Item 1 herein for a discussion of discontinued operations at Note (9) - Discontinued Operations.

***Summary of Performance***

We reported net income of \$7.6 million, or \$.27 per diluted common share, for the third quarter of 2008 compared to \$8.8 million, or \$.33 per diluted common share, for the third quarter of 2007. Return on average equity was 9.12% and return on average assets was .65% for the third quarter of 2008, compared to 12.73% and .88%, respectively, for the third quarter of 2007. Net income for the nine months ended September 30, 2008, totaled \$21.4 million, or \$.79 per diluted common share, compared to \$24.8 million, or \$.93 per common share, for the same period in 2007. Return on average equity was 9.03% and return on average assets was .64% for the nine months ended September 30, 2008, compared to 12.49% and .87%, respectively, for the same period in 2007.

Net income decreased \$1.3 million, or 14%, for the three months ended September 30, 2008 and decreased \$3.4 million, or 14%, for the nine months ended September 30, 2008 compared to the same periods in 2007. The decrease during the three months ended September 30, 2008 was primarily the result of a \$2.0 million increase in the provision for loan losses and a \$1.8 million increase in non-interest expense offset by a \$1.7 million increase in net interest income and an \$757,000 decrease in income tax expense. The \$3.4 million decrease during the nine months ended September 30, 2008 was primarily the result of an \$11.1 million increase in the provision for loan losses and a \$5.8 million increase in non-interest expense offset by a \$10.8 million increase in net interest income, a \$773,000 increase in non-interest income and a \$1.9 million decrease in income tax expense.



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Details of the changes in the various components of net income are further discussed below.

**Net Interest Income**

Net interest income was \$38.3 million for the third quarter of 2008, compared to \$36.5 million for the third quarter of 2007. The increase was due to an increase in average earning assets of \$626.5 million as compared to the third quarter of 2007. The increase in average earning assets included a \$585.8 million increase in average loans held for investment and an increase of \$138.1 million in loans held for sale, offset by a \$91.7 million decrease in average securities. For the quarter ended September 30, 2008, average net loans and securities represented 91% and 8%, respectively, of average earning assets compared to 88% and 12% in the same quarter of 2007.

Average interest bearing liabilities increased \$476.2 million from the third quarter of 2007, which included a \$135.9 million increase in interest bearing deposits and a \$340.3 million increase in other borrowings. The significant increase in average other borrowings is a result of the combined effects of maturities of transaction-specific deposits and growth in loans during the third quarter of 2008. The average cost of interest bearing liabilities decreased from 4.87% for the quarter ended September 30, 2007 to 2.58% for the same period of 2008.

Net interest income was \$113.0 million for the first nine months of 2008, compared to \$102.2 million for the same period of 2007. The increase was due to an increase in average earning assets of \$625.9 million as compared to 2007. The increase in average earning assets included a \$643.8 million increase in average loans held for investment and an increase of \$69.3 million in loans held for sale, offset by a \$82.6 million decrease in average securities. For the nine months ended September 30, 2008, average net loans and securities represented 90% and 10%, respectively, of average earning assets compared to 87% and 13% in the same period of 2007.

Average interest bearing liabilities increased \$500.0 million compared to the first nine months of 2007, which included a \$78.6 million increase in interest bearing deposits and a \$421.4 million increase in other borrowings. The significant increase in average other borrowings is a result of the combined effects of maturities of transaction-specific deposits and growth in loans during the first nine months of 2008. The average cost of interest bearing liabilities decreased from 4.90% for the nine months ended September 30, 2007 to 2.87% for the same period of 2008.

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The following table presents the changes (in thousands) in taxable-equivalent net interest income and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and the changes due to changes in the average interest rate on those assets and liabilities.

|                              | Three months ended<br>September 30, 2008/2007 |                              |            | Nine months ended<br>September 30, 2008/2007 |                              |            |
|------------------------------|---|------------------------------|------------|--|------------------------------|------------|
|                              | Change  | Change Due To <sup>(1)</sup> |            | Change                                       | Change Due To <sup>(1)</sup> |            |
|                              |   | Volume                       | Yield/Rate |  | Volume                       | Yield/Rate |
| Interest income:             |   |                              |            |  |                              |            |
| Securities <sup>(2)</sup>    | \$ (1,118)                                    | \$ (1,106)                   | \$ (12)    | \$ (3,094)                                   | \$ (2,919)                   | \$ (175)   |
| Loans held for sale          | 1,519   | 2,322                        | (803)      | 1,552  | 3,717                        | (2,165)    |
| Loans held for investment    | (14,329)                                      | 12,614                       | (26,943)   | (23,776)                                     | 40,724                       | (64,500)   |
| Federal funds sold           | 28  | 96                           | (68)       | 114  | 283                          | (169)      |
| Deposits in other banks      | (4)   | 15                           | (19)       | (14)   | 15                           | (29)       |
| Total                        | (13,904)                                      | 13,941                       | (27,845)   | (25,218)                                     | 41,820                       | (67,038)   |
| Interest expense:            |   |                              |            |  |                              |            |
| Transaction deposits         | (117)   | 19                           | (136)      | (361)  | 74                           | (435)      |
| Savings deposits             | (6,022)                                       | (773)                        | (5,249)    | (15,308)                                     | (615)                        | (14,693)   |
| Time deposits                | 647   | 6,407                        | (5,760)    | (1,305)                                      | 9,471                        | (10,776)   |
| Deposits in foreign branches | (8,860)                                       | (4,039)                      | (4,821)    | (19,560)                                     | (6,221)                      | (13,339)   |
| Borrowed funds               | (1,283)                                       | 4,539                        | (5,822)    | 513  | 16,460                       | (15,947)   |
| Total                        | (15,635)                                      | 6,153                        | (21,788)   | (36,021)                                     | 19,169                       | (55,190)   |
| Net interest income          | \$ 1,731                                      | \$ 7,788                     | \$ (6,057) | \$ 10,803                                    | \$22,651                     | \$(11,848) |

(1) Changes attributable to both volume and yield/rate are allocated to both volume and yield/rate on an equal basis.

(2) Taxable equivalent rates used where applicable.

Net interest margin from continuing operations, the ratio of net interest income to average earning assets from continuing operations, was 3.47% for the third quarter of 2008 compared to 3.85% for the third quarter of 2007. The decrease in net interest margin resulted primarily from a 237 basis point decrease in the yield on earning assets while

interest expense as a percentage of earning assets decreased by 199 basis points, due to growth, asset sensitivity, and the impact of the increase in non accrual loans.

### Non-interest Income

The components of non-interest income were as follows (in thousands):

|   | Three months ended |          | Nine months ended |          |
|---|--------------------|----------|-------------------|----------|
|   | September 30       |          | September 30      |          |
|   | 2008               | 2007     | 2008              | 2007     |
| Service charges on deposit accounts     | \$ 1,161           | \$ 1,089 | \$ 3,566          | \$ 2,935 |
| Trust fee income                        | 1,234              | 1,182    | 3,656             | 3,453    |
| Bank owned life insurance (BOLI) income | 299                | 288      | 925               | 887      |
| Brokered loan fees                      | 1,024              | 452      | 2,168             | 1,505    |
| Equipment rental income                 | 1,487              | 1,581    | 4,513             | 4,533    |
| Other                                   | (320)              | 283      | 1,692             | 2,434    |
| Total non-interest income               | \$4,885            | \$4,875  | \$16,520          | \$15,747 |

Non-interest income remained consistent at \$4.9 million as compared to the third quarter of 2007. Brokered loan fees increased \$572,000 from the third quarter of 2007 related to growth in mortgage warehouse, offset by a \$603,000 decrease in other non-interest income for the same period, which is primarily related to a \$1.0 million charge related to customer fraud on a specific group of mortgage loans.

Non-interest income increased \$773,000 during the nine months ended September 30, 2008 to \$16.5 million compared to \$15.7 million during the same period of 2007. The increase is primarily related to a \$631,000 increase in service charges on deposit accounts from \$2.9 million to \$3.6 million, which is attributed to lower earnings credit rates based on market rates, certain price changes, and increase in demand deposit balances. Brokered loan fees increased \$663,000 from \$1.5 million to \$2.2 million, which is attributed to growth in mortgage warehouse. Trust fee income increased \$203,000 due to continued growth of trust assets.

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While management expects continued growth in non-interest income, the future rate of growth could be affected by increased competition from nationwide and regional financial institutions. In order to achieve continued growth in non-interest income, we may need to introduce new products or enter into new markets. Any new product introduction or new market entry would likely place additional demands on capital and managerial resources.

**Non-interest Expense**

The components of non-interest expense were as follows (in thousands):

|                                    | Three months ended |          | Nine months ended |          |
|------------------------------------|--------------------|----------|-------------------|----------|
|                                    | September 30       |          | September 30      |          |
|                                    | 2008               | 2007     | 2008              | 2007     |
| Salaries and employee benefits     | \$16,039           | \$15,254 | \$46,750          | \$44,573 |
| Net occupancy expense              | 2,300              | 2,194    | 7,097             | 6,269    |
| Leased equipment depreciation      | 1,153              | 1,311    | 3,525             | 3,722    |
| Marketing                          | 521                | 669      | 1,847             | 2,154    |
| Legal and professional             | 2,338              | 1,799    | 6,829             | 5,202    |
| Communications and data processing | 804                | 849      | 2,428             | 2,519    |
| Other                              | 4,520              | 3,818    | 12,732            | 10,961   |
| Total non-interest expense         | \$27,675           | \$25,894 | \$81,208          | \$75,400 |

Non-interest expense for the third quarter of 2008 increased \$1.8 million, or 7%, to \$27.7 million from \$25.9 million, and is primarily attributable to a \$785,000 increase in salaries and employee benefits to \$16.0 million from \$15.3 million, which was primarily due to general business growth.

Occupancy expense for the three months ended September 30, 2008 increased \$106,000, or 5%, compared to the same quarter in 2007 related to general business growth.

Marketing expense decreased \$148,000, or 22%. Marketing expense for the three months ended September 30, 2008 included \$45,000 of direct marketing and promotions and \$287,000 for business development compared to direct marketing and promotions of \$100,000 and business development of \$347,000 during the same period for 2007.

Marketing expense for the three months ended September 30, 2008 also included \$189,000 for the purchase of miles related to the American Airlines AAdvantage® program compared to \$222,000 for the same period for 2007. Our direct marketing may increase as we seek to further develop our brand, reach more of our target customers and expand in our target markets.

Legal and professional expense for the three months ended September 30, 2008 increased \$539,000, or 30% compared to the same quarter in 2007 mainly related to business growth, increase in non-performing assets and continued regulatory and compliance costs.

Non-interest expense for the first nine months of 2008 increased \$5.8 million, or 8%, to \$81.2 million from \$75.4 million during the same period in 2007. This increase is primarily related to a \$2.2 million increase in salaries and employee benefits to \$46.8 million from \$44.6 million, which was primarily due to general business growth.

Occupancy expense for the nine months ended September 30, 2008 increased \$828,000, or 13%, to \$7.1 million from \$6.3 million compared to the same period in 2007 related to general business growth.

Marketing expense decreased \$307,000, or 14%, compared to the first nine months of 2007. Marketing expense for the nine months ended September 30, 2008 included \$230,000 of direct marketing and promotions and \$1.0 million for business development compared to direct marketing and promotions of \$317,000 and business development of \$1.2 million during the same period for 2007. Marketing expense for the nine months ended September 30, 2008 also included \$567,000 for the purchase of miles related to the American Airlines AAdvantage® program, compared to \$844,000 for the same period for 2007. Our direct marketing expense may increase as we seek to further develop our brand, reach more of our target customers and expand in our target markets.



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Legal and professional expense for the nine months ended September 30, 2008 increased \$1.6 million, or 31%, compared to the same period in 2007 mainly related to business growth, increase in non-performing assets and continued regulatory and compliance costs.

**Analysis of Financial Condition**

The aggregate loan portfolio at September 30, 2008 increased \$538.2 million from December 31, 2007 to \$4.1 billion. Commercial loans, construction, real estate and consumer loans increased \$121.9 million, \$59.7 million, \$182.3 million and \$7.2 million, respectively. Leases also increased \$6.5 million. Loans held for sale increased \$168.8 million.

Loans were as follows as of the dates indicated (in thousands):

|   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| Commercial  | \$2,156,950           | \$2,035,049          |
| Construction                                      | 633,121               | 573,459              |
| Real estate                                       | 956,280               | 773,970              |
| Consumer  | 35,540                | 28,334               |
| Leases  | 80,994                | 74,523               |
| Gross loans held for investment                   | 3,862,885             | 3,485,335            |
| Deferred income (net of direct origination costs) | (22,713)              | (22,727)             |
| Allowance for loan losses                         | (40,998)              | (32,821)             |
| Total loans held for investment, net              | 3,799,174             | 3,429,787            |
| Loans held for sale                               | 343,002               | 174,166              |
| Total   | \$4,142,176           | \$3,603,953          |

We continue to lend primarily in Texas. As of September 30, 2008, a substantial majority of the principal amount of the loans in our portfolio was to businesses and individuals in Texas. This geographic concentration subjects the loan portfolio to the general economic conditions within this area. We originate substantially all of the loans in our portfolio, except in certain instances we have purchased selected loan participations and interests in certain syndicated credits and USDA government guaranteed loans.

**Summary of Loan Loss Experience**

During the third quarter of 2008, the Company recorded net charge-offs in the amount of \$1.5 million, compared to net charge-offs of \$59,000 for the same period in 2007. The reserve for loan losses, which is available to absorb losses inherent in the loan portfolio, totaled \$41.0 million at September 30, 2008, \$32.8 million at December 31, 2007 and \$26.0 million at September 30, 2007. This represents 1.07%, 0.95% and 0.79% of loans held for investment (net of unearned income) at September 30, 2008, December 31, 2007 and September 30, 2007, respectively.

The provision for loan losses is a charge to earnings to maintain the reserve for loan losses at a level consistent with management's assessment of the loan portfolio in light of current economic conditions and market trends. We recorded a \$4.0 million provision for loan losses during the third quarter of 2008 compared to \$2.0 million in the third quarter of 2007 and \$8.0 million in the second quarter of 2008.

The reserve for loan losses is comprised of specific reserves for impaired loans and an estimate of losses inherent in the portfolio at the balance sheet date, but not yet identified with specified loans. We regularly evaluate our reserve for loan losses to maintain an adequate level to absorb estimated loan losses inherent in the loan portfolio. Factors contributing to the determination of specific reserves include the credit worthiness of the borrower, changes in the value of pledged collateral, and general economic conditions. All loan commitments rated substandard or worse and greater than \$1,000,000 are specifically reviewed for impairment. For loans deemed to be impaired, a specific

allocation is assigned based on the losses expected to be realized from those loans. For purposes of determining the general reserve, the portfolio, excluding any impaired loans, is segregated by product types to recognize differing risk profiles among categories, and then further segregated by credit grades. Credit grades are assigned to all loans greater than \$50,000. Each credit grade is assigned a risk factor,

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or reserve allocation percentage. These risk factors are multiplied by the outstanding principal balance and risk-weighted by product type to calculate the required reserve. A similar process is employed to calculate that portion of the required reserve assigned to unfunded loan commitments. Even though portions of the allowance may be allocated to specific loans, the entire allowance is available for any credit that, in management's judgment, should be charged off.

The reserve allocation percentages assigned to each credit grade have been developed based primarily on an analysis of our historical loss rates and historical loss rates at selected peer banks, adjusted for certain qualitative factors. Qualitative adjustments for such things as general economic conditions, changes in credit policies and lending standards and changes in the trend and severity of problem loans, can cause the estimation of future losses to differ from past experience. In addition, the reserve considers the results of reviews performed by independent third party reviewers as reflected in their confirmations of assigned credit grades within the portfolio. The portion of the allowance that is not derived by the allowance allocation percentages compensates for the uncertainty and complexity in estimating loan and lease losses including factors and conditions that may not be fully reflected in the determination and application of the allowance allocation percentages. We evaluate many factors and conditions in determining the unallocated portion of the allowance, including the economic and business conditions affecting key lending areas, credit quality trends and general growth in the portfolio. The allowance is considered adequate and appropriate, given management's assessment of potential losses within the portfolio as of the evaluation date, the significant growth in the loan and lease portfolio, current economic conditions in our market areas and other factors.

The methodology used in the periodic review of reserve adequacy, which is performed at least quarterly, is designed to be dynamic and responsive to changes in portfolio credit quality and anticipated future credit losses. The changes are reflected in the general reserve and in specific reserves as the collectability of larger classified loans is evaluated with new information. As our portfolio has matured, historical loss ratios have been closely monitored, and our reserve adequacy relies primarily on our loss history. Currently, the review of reserve adequacy is performed by executive management and presented to our board of directors for their review, consideration and ratification on a quarterly basis.



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Activity in the allowance for possible loan losses is presented in the following table (in thousands).

|   | Nine months<br>ended<br>September<br>30,<br>2008 | Nine months<br>ended<br>September 30,<br>2007 | Year ended<br>December<br>31,<br>2007 |
|---|--|---|---------------------------------------|
| Beginning balance   | \$32,821   | \$ 21,003                                     | \$21,003                              |
| Loans charged-off:  |  |   |                                       |
| Commercial  | 6,843  | 339   | 2,528                                 |
| Real estate construction  | 671  |   | 313                                   |
| Real estate permanent   | 736  |   |                                       |
| Consumer  | 129  | 48  | 48                                    |
| Leases  | 29   | 68  | 81                                    |
| Total charge-offs   | 8,408  | 455   | 2,970                                 |
| Recoveries:   |  |   |                                       |
| Commercial  | 716  | 625   | 642                                   |
| Real estate permanent   | 27   |   |                                       |
| Consumer  | 13   | 14  | 15                                    |
| Leases  | 79   | 116   | 131                                   |
| Total recoveries  | 835  | 755   | 788                                   |
| Net charge-offs (recoveries)                                    | 7,573  | (300)   | 2,182                                 |
| Provision for loan losses                                       | 15,750   | 4,700   | 14,000                                |
| Ending balance  | \$40,998   | \$ 26,003                                     | \$32,821                              |
| Reserve to loans held for investment <sup>(2)</sup>             | 1.07%  | .79%  | .95%                                  |
| Net charge-offs (recoveries) to average loans <sup>(1)(2)</sup> | .28%   | (.01)%  | .07%                                  |
| Provision for loan losses to average loans <sup>(1)(2)</sup>    | .58%   | .21%  | .46%                                  |
| Recoveries to total charge-offs                                 | 9.93%  | 165.93%                                       | 26.53%                                |
| Reserve as a multiple of net charge-offs                        | 5.4x   | N/M   | 15.0x                                 |
| Non-performing and renegotiated loans:                          |  |   |                                       |
| Non-accrual <sup>(4)</sup>                                      | \$46,579   | \$ 8,690                                      | \$21,385                              |
| Loans past due 90 days and accruing <sup>(3) (4)</sup>          | 2,970  | 4,356   | 4,147                                 |
| Total   | \$49,549   | \$ 13,046                                     | \$25,532                              |
| Other real estate owned <sup>(4)</sup>                          | \$ 5,792   | \$ 501  | \$ 2,671                              |
| Reserve as a percent of non-performing loans <sup>(2)</sup>     | .8x  | 2.0x  | 1.3x                                  |

(1) Interim period ratios are

annualized.

- (2) Excludes loans held for sale.
- (3) At September 30, 2008, \$2.1 million of the loans past due 90 days and still accruing are premium finance loans. These loans are generally secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take up to 180 days or longer from the cancellation date.
- (4) At September 30, 2008, non-performing assets include \$4.4 million of mortgage warehouse loans that were transferred from loans held for sale to loans held for investment at lower of cost or market and some

subsequently  
moved to other  
real estate  
owned.

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Non-performing assets include non-accrual loans and leases, accruing loans 90 or more days past due, restructured loans, and other repossessed assets. The table below summarizes our non-accrual loans by type (in thousands):

|                         | September<br>30,<br>2008 | December<br>31,<br>2007 | September<br>30,<br>2007 |
|-------------------------|--------------------------|-------------------------|--------------------------|
| Non-accrual loans:      |                          |                         |                          |
| Commercial              | \$ 1,525                 | \$ 14,693               | \$ 2,601                 |
| Construction            | 23,349                   | 4,147                   | 4,952                    |
| Real estate             | 21,121                   | 2,453                   | 1,118                    |
| Consumer                | 119                      | 90                      | 12                       |
| Leases                  | 465                      | 2                       | 7                        |
| Total non-accrual loans | \$46,579                 | \$21,385                | \$ 8,690                 |

At September 30, 2008, our total non-accrual loans were \$46.6 million. Of these \$23.3 million were characterized as construction loans. This included an \$8.8 million residential real estate development loan secured by approximately 80 single family residences and fully-developed residential lots. The loan was subsequently foreclosed in October 2008 with the collateral properties transferred to ORE net of a \$1 million charge-off that was fully reserved and included in the allowance for loan losses as of September 30, 2008. Also included in the construction category was an \$8.9 million residential real estate development loan secured by fully-developed residential lots and unimproved land. We believe specific reserves allocated to this credit as of September 30, 2008 are adequate based upon our assessment of impairment which was based upon the value of our collateral. \$21.1 million of our non-accrual loans are characterized as real estate loans. This includes a \$9.4 million loan secured by commercial property on which the bank earlier committed to finance the construction of a shopping center. A \$3.3 million loan is secured by an office building; and, a \$1.7 million loan is secured by a commercial lot. Real estate loans also include \$3.6 million of single family mortgages that were originated in our mortgage warehouse operation. Each of these real estate loans were reviewed for impairment and specific reserves were allocated as necessary and included in the allowance for loan losses as of September 30, 2008 to cover any probable loss.

At September 30, 2008, we had \$3.0 million in loans past due 90 days and still accruing interest. At September 30, 2008, \$2.1 million of the loans past due 90 days and still accruing are premium finance loans. These loans are generally secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take up to 180 days or longer from the cancellation date. At September 30, 2008, we had \$5.8 million in other repossessed assets and real estate.

Generally, we place loans on non-accrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. When a loan is placed on non-accrual status, all previously accrued and unpaid interest is reversed. Interest income is subsequently recognized on a cash basis as long as the remaining unpaid principal amount of the loan is deemed to be fully collectible. If collectability is questionable, then cash payments are applied to principal. As of September 30, 2008, approximately \$999,000 of our non-accrual loans were earning on a cash basis.

A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. Reserves on impaired loans are measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral.

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which we have concerns about the borrower's ability to comply with repayment terms because of the borrower's potential financial difficulties. We monitor these loans closely and review their performance on a regular basis. At

September 30, 2008, we had a \$7.0 million loan of this type which was not included in either non-accrual or 90 days past due categories.

**Table of Contents****Liquidity and Capital Resources**

In general terms, liquidity is a measurement of our ability to meet our cash needs. Our objective in managing our liquidity is to maintain our ability to meet loan commitments, purchase securities or repay deposits and other liabilities in accordance with their terms, without an adverse impact on our current or future earnings. Our liquidity strategy is guided by policies, which are formulated and monitored by our senior management and our Balance Sheet Management Committee ( BSMC ), and which take into account the marketability of assets, the sources and stability of funding and the level of unfunded commitments. We regularly evaluate all of our various funding sources with an emphasis on accessibility, stability, reliability and cost-effectiveness. For the year ended December 31, 2007 and for the nine months ended September 30, 2008, our principal source of funding has been our customer deposits, supplemented by our short-term and long-term borrowings, primarily from securities sold under repurchase agreements and federal funds purchased from our downstream correspondent bank relationships (which consist of banks that are considered to be smaller than our bank) and the Federal Home Loan Bank ( FHLB ) borrowings. Our liquidity needs have typically been fulfilled through growth in our core customer deposits, and supplemented with brokered deposits and borrowings as needed. Our goal is to obtain as much of our funding as possible from deposits of these core customers, which as of September 30, 2008, comprised \$2,731.9 million, or 80.6%, of total deposits. On an average basis, for the quarter ended September 30, 2008, deposits from core customers comprised \$2,890.2 million, or 83.9%, of total quarterly average deposits. These deposits are generated principally through development of long-term relationships with customers and stockholders and our retail network which is mainly through BankDirect.

In addition to deposits from our core customers, we also have access to incremental deposits through brokered retail certificates of deposit, or CDs. These CDs are generally of short maturities, 90 to 180 days or less, and are used to supplement temporary differences in the growth in loans, including growth in specific categories of loans, compared to customer deposits. As of September 30, 2008, brokered retail CDs comprised \$657.0 million, or 19.4%, of total deposits. On an average basis, for the quarter ended September 30, 2008, brokered retail CDs comprised \$556.6 million, or 16.1%, of total quarterly average deposits. We believe the Company has access to sources of brokered deposits of not less than an additional \$1.2 billion.

Additionally, we have borrowing sources available to supplement deposits and meet our funding needs. These borrowing sources include federal funds purchased from our downstream correspondent bank relationships (which consist of banks that are smaller than our bank) and from our upstream correspondent bank relationships (which consist of banks that are larger than our bank), customer repurchase agreements, treasury, tax and loan notes, and advances from the FHLB. As of September 30, 2008, our borrowings consisted of a total of \$42.0 million of customer repurchase agreements, \$125.0 million of upstream federal funds purchased, \$115.4 million of downstream federal funds purchased and \$2.6 million in treasury, tax and loan notes. Credit availability from the FHLB is based on our bank's financial and operating condition and borrowing collateral we hold with the FHLB. At September 30, 2008, we had \$500.0 million in borrowings from the FHLB. FHLB borrowings are collateralized by eligible securities and loans. Our unused FHLB borrowing capacity at September 30, 2008 was approximately \$383.1 million. As of September 30, 2008, we had unused upstream federal fund lines available from commercial banks of approximately \$527.3 million. During the nine months ended September 30, 2008, our average other borrowings from these sources were \$770.7 million. The maximum amount of borrowed funds outstanding at any month-end during the first nine months of 2008 was \$955.4 million.

Our equity capital averaged \$316.3 million for the nine months ended September 30, 2008 as compared to \$265.7 million for the same period in 2007. This increase reflects our retention of net earnings during this period. We have not paid any cash dividends on our common stock since we commenced operations and have no plans to do so in the near future.

On September 10, 2008, we completed a sale of 4 million shares of our common stock in a private placement to a number of institutional investors. The purchase price was \$14.50 per share, and net proceeds from the sale totaled \$55 million. The new capital will be used for general corporate purposes, including capital for support of anticipated growth of our bank.

In response to the recent national financial crisis, the U.S. government is taking various actions in an attempt to stabilize financial markets. One of those actions includes the U.S. Treasury Department's Troubled Asset Relief

Program, which offers to U.S. banking organizations the opportunity to sell preferred stock, along with

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warrants to purchase common stock, to the U.S. Treasury. In addition, the FDIC has initiated the Temporary Liquidity Guarantee Program that will provide a 100 percent guarantee for a limited period of time to newly issued senior unsecured debt and non-interest bearing deposits. Our capital ratios remain above the levels required to be well capitalized and have been enhanced with our recent sale of common stock with net proceeds of \$55 million, which is discussed above. However, based on the advantageous terms of the above two programs, we are assessing our participation in both programs and have not yet determined whether we will participate.

As of September 30, 2008, our significant fixed and determinable contractual obligations to third parties were as follows (in thousands):

|  | Within<br>One Year | After One<br>but Within<br>Three<br>Years | After<br>Three<br>but Within<br>Five Years | After Five<br>Years | Total        |
|--|--------------------|---|--|---------------------|--------------|
| Deposits without a stated maturity<br>(1)      | \$ 1,386,329       | \$  | \$   | \$                  | \$ 1,386,329 |
| Time deposits (1)                              | 1,955,726          | 37,021                                    | 9,822                                      | 65                  | 2,002,634    |
| Federal funds purchased (1)                    | 240,405            |   |  |                     | 240,405      |
| Customer repurchase agreements (1)             | 42,032             |   |  |                     | 42,032       |
| Treasury, tax and loan notes (1)               | 2,588              |   |  |                     | 2,588        |
| FHLB borrowing (1)                             | 500,000            |   |  |                     | 500,000      |
| Short-term borrowing (1)                       | 50,000             |   |  |                     | 50,000       |
| Operating lease obligations (2)                | 7,368              | 12,294                                    | 9,762                                      | 38,342              | 67,766       |
| Trust preferred subordinated<br>debentures (1) |                    |   |  | 113,406             | 113,406      |
| Total contractual obligations                  | \$ 4,184,448       | \$ 49,315                                 | \$ 19,584                                  | \$ 151,813          | \$ 4,405,160 |

(1) Excludes interest

(2) Non-balance sheet item.

**Critical Accounting Policies**

SEC guidance requires disclosure of critical accounting policies. The SEC defines critical accounting policies as those that are most important to the presentation of a company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

We follow financial accounting and reporting policies that are in accordance with accounting principles generally accepted in the United States. The more significant of these policies are summarized in Note 1 to the consolidated financial statements. Not all these significant accounting policies require management to make difficult, subjective or complex judgments. However, the policies noted below could be deemed to meet the SEC's definition of critical accounting policies.

Management considers the policies related to the allowance for loan losses as the most critical to the financial statement presentation. The total allowance for loan losses includes activity related to allowances calculated in accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan, and SFAS No. 5, Accounting for Contingencies. The allowance for loan losses is established through a provision for loan losses charged to current earnings. The amount maintained in the allowance reflects management's continuing evaluation of the loan losses



inherent in the loan portfolio. The allowance for loan losses is comprised of specific reserves assigned to certain classified loans and general reserves. Factors contributing to the determination of specific reserves include the credit-worthiness of the borrower, and more specifically, changes in the expected future receipt of principal and interest payments and/or in the value of pledged collateral. A reserve is recorded when the carrying amount of the loan exceeds the discounted estimated cash flows using the loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. For purposes of determining the general reserve, the portfolio is segregated by product types in order to recognize differing risk profiles among categories, and then further segregated by credit grades. See "Summary of Loan Loss Experience" in Part I, Item 2 herein for further discussion of the risk factors considered by management in establishing the allowance for loan losses.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is a broad term for the risk of economic loss due to adverse changes in the fair value of a financial instrument. These changes may be the result of various factors, including interest rates, foreign exchange rates, commodity prices, or equity prices. Additionally, the financial instruments subject to market risk can be classified either as held for trading purposes or held for other than trading.

We are subject to market risk primarily through the effect of changes in interest rates on our portfolio of assets held for purposes other than trading. The effect of other changes, such as foreign exchange rates, commodity prices, and/or equity prices do not pose significant market risk to us.

The responsibility for managing market risk rests with the BSMC, which operates under policy guidelines established by our board of directors. The negative acceptable variation in net interest revenue due to a 200 basis point increase or decrease in interest rates is generally limited by these guidelines to +/- 5%. These guidelines also establish maximum levels for short-term borrowings, short-term assets and public and brokered deposits. They also establish minimum levels for unpledged assets, among other things. Compliance with these guidelines is the ongoing responsibility of the BSMC, with exceptions reported to our board of directors on a quarterly basis.

**Interest Rate Risk Management**

Our interest rate sensitivity is illustrated in the following table. The table reflects rate-sensitive positions as of September 30, 2008, and is not necessarily indicative of positions on other dates. The balances of interest rate sensitive assets and liabilities are presented in the periods in which they next reprice to market rates or mature and are aggregated to show the interest rate sensitivity gap. The mismatch between repricings or maturities within a time period is commonly referred to as the gap for that period. A positive gap (asset sensitive), where interest rate sensitive assets exceed interest rate sensitive liabilities, generally will result in the net interest margin increasing in a rising rate environment and decreasing in a falling rate environment. A negative gap (liability sensitive) will generally have the opposite results on the net interest margin. To reflect anticipated prepayments, certain asset and liability categories are shown in the table using estimated cash flows rather than contractual cash flows.

**Table of Contents****Interest Rate Sensitivity Gap Analysis  
September 30, 2008**

(In thousands)

|  | 0-3 mo<br>Balance | 4-12 mo<br>Balance | 1-3 yr<br>Balance | 3+ yr<br>Balance | Total<br>Balance |
|--|-------------------|--------------------|-------------------|------------------|------------------|
| Securities <sup>(1)</sup>  | \$ 20,542         | \$ 51,845          | \$ 134,048        | \$ 158,710       | \$ 365,145       |
| Total variable loans   | 3,509,363         | 33,083             | 21,357            |                  | 3,563,803        |
| Total fixed loans  | 192,437           | 152,587            | 198,169           | 99,539           | 642,732          |
| Total loans <sup>(2)</sup>   | 3,701,800         | 185,670            | 219,526           | 99,539           | 4,206,535        |
| Total interest sensitive assets                                    | \$ 3,722,342      | \$ 237,515         | \$ 353,574        | \$ 258,249       | \$ 4,571,680     |
| Liabilities:   |                   |                    |                   |                  |                  |
| Interest bearing customer deposits                                 | \$ 1,508,894      | \$                 | \$                | \$               | \$ 1,508,894     |
| CD s & IRA s   | 389,458           | 225,519            | 36,939            | 9,888            | 661,804          |
| Wholesale deposits   | 648,504           | 8,452              | 82                |                  | 657,038          |
| Total interest bearing deposits                                    | 2,546,856         | 233,971            | 37,021            | 9,888            | 2,827,736        |
| Repurchase agreements, Federal<br>funds purchased, FHLB borrowings | 835,025           |                    |                   |                  | 835,025          |
| Trust preferred subordinated<br>debentures                         |                   |                    |                   | 113,406          | 113,406          |
| Total borrowings   | 835,025           |                    |                   | 113,406          | 948,431          |
| Total interest sensitive liabilities                               | \$ 3,381,881      | \$ 233,971         | \$ 37,021         | \$ 123,294       | \$ 3,776,167     |
| GAP  | 340,461           | 3,544              | 316,553           | 134,955          |                  |
| Cumulative GAP   | 340,461           | 344,005            | 660,558           | 795,513          | 795,513          |
| Demand deposits  |                   |                    |                   |                  | \$ 561,227       |
| Stockholders' equity   |                   |                    |                   |                  | 380,858          |
| Total  |                   |                    |                   |                  | \$ 942,085       |

(1) Securities based  
on fair market  
value.

(2)

Loans include  
loans held for  
sale and are  
stated at gross.

The table above sets forth the balances as of September 30, 2008 for interest bearing assets, interest bearing liabilities, and the total of non-interest bearing deposits and stockholders' equity. While a gap interest table is useful in analyzing interest rate sensitivity, an interest rate sensitivity simulation provides a better illustration of the sensitivity of earnings to changes in interest rates. Earnings are also affected by the effects of changing interest rates on the value of funding derived from demand deposits and stockholders' equity. We perform a sensitivity analysis to identify interest rate risk exposure on net interest income. We quantify and measure interest rate risk exposure using a model to dynamically simulate the effect of changes in net interest income relative to changes in interest rates and account balances over the next twelve months based on three interest rate scenarios. These are a most likely rate scenario and two shock test scenarios.

The most likely rate scenario is based on the consensus forecast of future interest rates published by independent sources. These forecasts incorporate future spot rates and relevant spreads of instruments that are actively traded in the open market. The Federal Reserve's Federal Funds target affects short-term borrowing; the prime lending rate and the LIBOR are the basis for most of our variable-rate loan pricing. The 10-year mortgage rate is also monitored because of its effect on prepayment speeds for mortgage-backed securities. These are our primary interest rate exposures. We are currently not using derivatives to manage our interest rate exposure.

The two shock test scenarios assume a sustained parallel 200 basis point increase or decrease, respectively, in interest rates. As short-term rates continued to fall during 2008, we could not assume interest rate changes of 200 basis points as the results of the decreasing rates scenario would be 25 basis points. Therefore, our

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shock test scenarios with respect to decreases in rates now assume a decrease of 100 basis points in the current interest rate environment. We will continue to evaluate these scenarios as interest rates change, until short-term rates rise above 3.0%.

Our interest rate risk exposure model incorporates assumptions regarding the level of interest rate or balance changes on indeterminable maturity deposits (demand deposits, interest bearing transaction accounts and savings accounts) for a given level of market rate changes. These assumptions have been developed through a combination of historical analysis and future expected pricing behavior. Changes in prepayment behavior of mortgage-backed securities, residential and commercial mortgage loans in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. The impact of planned growth and new business activities is factored into the simulation model. This modeling indicated interest rate sensitivity as follows (in thousands):

|                               | Anticipated Impact Over the Next Twelve Months |                    |
|-------------------------------|--|--------------------|
|                               | as Compared to Most Likely Scenario            |                    |
|                               | 200 bp Increase                                | 100 bp Decrease    |
|                               | September 30, 2008                             | September 30, 2008 |
| Change in net interest income | \$ 18,267                                      | \$ (1,517)         |

The simulations used to manage market risk are based on numerous assumptions regarding the effect of changes in interest rates on the timing and extent of repricing characteristics, future cash flows, and customer behavior. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies, among other factors.

**ITEM 4. CONTROLS AND PROCEDURES**

Our management, including our chief executive officer and chief financial officer, have evaluated our disclosure controls and procedures as of September 30, 2008, and concluded that those disclosure controls and procedures are effective. There have been no changes in our internal controls or in other factors known to us that could materially affect these controls subsequent to their evaluation, nor any corrective actions with regard to significant deficiencies and material weaknesses. While we believe that our existing disclosure controls and procedures have been effective to accomplish these objectives, we intend to continue to examine, refine and formalize our disclosure controls and procedures and to monitor ongoing developments in this area.

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**PART II OTHER INFORMATION**

**ITEM 1A. RISK FACTORS**

There has not been any material change in the risk factors previously disclosed in the Company's 2007 Form 10-K for the fiscal year ended December 31, 2007.

**ITEM 6. EXHIBITS**

(a) Exhibits

- 3.1 Certificate of Amendment of Certificate of Incorporation dated May 21, 2002, filed herewith
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
- 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

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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.

TEXAS CAPITAL BANCSHARES, INC.

Date: October 30, 2008

/s/ Peter B. Bartholow

Peter B. Bartholow  
Chief Financial Officer  
(Duly authorized officer and principal financial officer)

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**EXHIBIT INDEX**

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