

PLAINS ALL AMERICAN PIPELINE LP

Form 10-Q

November 07, 2007

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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, 2007**

**OR**

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

**Commission file number: 1-14569  
PLAINS ALL AMERICAN PIPELINE, L.P.  
(Exact name of registrant as specified in its charter)**

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**76-0582150**  
(I.R.S. Employer  
Identification No.)

**333 Clay Street, Suite 1600, Houston, Texas 77002**  
(Address of principal executive offices) (Zip Code)  
**(713) 646-4100**

(Registrant's telephone number, including area code)

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

At November 5, 2007, there were outstanding 115,981,676 Common Units.

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**Table of Contents****PART I. FINANCIAL INFORMATION**

**Item 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**PLAINS ALL AMERICAN PIPELINE, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in millions, except units)

	<b>September 30, 2007</b>	<b>December 31, 2006</b> <b>(unaudited)</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 12.5	\$ 11.3
Trade accounts receivable and other receivables, net	2,098.0	1,725.4
Inventory	964.9	1,290.0
Other current assets	109.2	130.9
Total current assets	3,184.6	3,157.6
<b>PROPERTY AND EQUIPMENT</b>		
Accumulated depreciation	4,751.9 (479.2)	4,190.1 (348.1)
	4,272.7	3,842.0
<b>OTHER ASSETS</b>		
Pipeline linefill in owned assets	240.5	265.5
Inventory in third-party assets	63.0	75.7
Investment in unconsolidated entities	212.9	183.0
Goodwill	1,059.2	1,026.2
Other, net	154.3	164.9
Total assets	\$ 9,187.2	\$ 8,714.9
<b>LIABILITIES AND PARTNERS CAPITAL</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities	\$ 2,358.0	\$ 1,846.6
Short-term debt	481.1	1,001.2
Other current liabilities	181.0	176.9
Total current liabilities	3,020.1	3,024.7
<b>LONG-TERM LIABILITIES</b>		
Long-term debt under credit facilities and other	1.2	3.1

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Senior notes, net of unamortized net discount of \$2.0 and \$1.8, respectively	2,623.0	2,623.2
Other long-term liabilities and deferred credits	119.7	87.1
Total long-term liabilities	2,743.9	2,713.4

**COMMITMENTS AND CONTINGENCIES (NOTE 12)**

**PARTNERS CAPITAL**

Common unitholders (115,981,676 and 109,405,178 units outstanding at September 30, 2007 and December 31, 2006, respectively)	3,342.9	2,906.1
General partner	80.3	70.7
Total partners capital	3,423.2	2,976.8
Total liabilities and partners capital	\$ 9,187.2	\$ 8,714.9

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

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**PLAINS ALL AMERICAN PIPELINE, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in millions, except per unit data)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(unaudited)		(unaudited)	
<b>REVENUES</b>				
Crude oil, refined products and LPG sales and related revenues (includes buy/sell transactions of \$4,761.9 in the first three months of 2006)	\$ 5,673.2	\$ 4,449.4	\$ 13,581.9	\$ 17,843.8
Pipeline tariff activities revenues	93.2	71.4	272.7	198.4
Other revenues	32.6	4.7	91.7	10.4
<b>Total revenues</b>	<b>5,799.0</b>	<b>4,525.5</b>	<b>13,946.3</b>	<b>18,052.6</b>
<b>COSTS AND EXPENSES</b>				
Crude oil, refined products and LPG purchases and related costs (includes buy/sell transactions of \$4,795.1 in the first three months of 2006)	5,455.2	4,261.5	12,884.4	17,343.3
Field operating costs	133.4	94.0	394.8	268.6
General and administrative expenses	33.4	33.0	127.9	92.2
Depreciation and amortization	42.9	24.2	134.9	67.1
<b>Total costs and expenses</b>	<b>5,664.9</b>	<b>4,412.7</b>	<b>13,542.0</b>	<b>17,771.2</b>
<b>OPERATING INCOME</b>	<b>134.1</b>	<b>112.8</b>	<b>404.3</b>	<b>281.4</b>
<b>OTHER INCOME/(EXPENSE)</b>				
Equity earnings in unconsolidated entities	3.8	1.5	12.4	3.2
Interest expense (net of capitalized interest of \$4.1 and \$1.7 in the three months and \$9.8 and \$3.4 in the nine months ended September 30, 2007 and 2006, respectively)	(38.8)	(19.2)	(121.1)	(52.5)
Interest income and other income (expense), net	2.5	0.3	7.7	0.7
Income before tax	101.6	95.4	303.3	232.8
Current income tax expense	(0.4)		(1.3)	
Deferred income tax expense	(2.8)		(14.1)	
Income before cumulative effect of change in accounting principle	98.4	95.4	287.9	232.8
Cumulative effect of change in accounting principle				6.3

<b>NET INCOME</b>	\$ 98.4	\$ 95.4	\$ 287.9	\$ 239.1
<b>NET INCOME-LIMITED PARTNERS</b>	\$ 76.8	\$ 84.6	\$ 231.3	\$ 212.7
<b>NET INCOME-GENERAL PARTNER</b>	\$ 21.6	\$ 10.8	\$ 56.6	\$ 26.4
<b>BASIC NET INCOME PER LIMITED PARTNER UNIT</b>				
Income before cumulative effect of change in accounting principle	\$ 0.66	\$ 0.90	\$ 2.06	\$ 2.37
Cumulative effect of change in accounting principle				0.08
Net income	\$ 0.66	\$ 0.90	\$ 2.06	\$ 2.45
<b>DILUTED NET INCOME PER LIMITED PARTNER UNIT</b>				
Income before cumulative effect of change in accounting principle	\$ 0.66	\$ 0.89	\$ 2.05	\$ 2.35
Cumulative effect of change in accounting principle				0.08
Net income	\$ 0.66	\$ 0.89	\$ 2.05	\$ 2.43
<b>BASIC WEIGHTED AVERAGE UNITS OUTSTANDING</b>				
	116.0	79.9	112.1	77.0
<b>DILUTED WEIGHTED AVERAGE UNITS OUTSTANDING</b>				
	116.8	80.8	113.0	77.8

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

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**PLAINS ALL AMERICAN PIPELINE, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in millions)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>
	(unaudited)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 287.9	\$ 239.1
Adjustments to reconcile to cash flows from operating activities:		
Depreciation and amortization	134.9	67.1
Cumulative effect of change in accounting principle		(6.3)
SFAS 133 mark-to-market adjustment	14.8	(14.8)
Gain on sale of investment assets	(3.9)	
Equity compensation charge	41.4	27.1
Income tax expense	15.4	
Noncash amortization of terminated interest rate hedging instruments	0.6	1.2
(Gain)/loss on foreign currency revaluation	(3.2)	2.1
Equity earnings in unconsolidated entities, net of distributions	(11.1)	(2.1)
Changes in assets and liabilities, net of acquisitions:		
Trade accounts receivable and other	(288.6)	(595.4)
Inventory	410.2	(414.6)
Accounts payable and other liabilities	368.3	512.4
Inventory in third-party assets	0.1	
Due to related parties	1.7	2.3
Net cash provided by (used in) operating activities	968.5	(181.9)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Cash paid in connection with acquisitions (Note 3)	(69.2)	(560.2)
Additions to property and equipment, net	(401.8)	(223.1)
Investment in unconsolidated entities	(9.3)	(10.0)
Cash paid for linefill in assets owned	(17.6)	(4.8)
Proceeds from sales of assets	13.7	3.8
Net cash used in investing activities	(484.2)	(794.3)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net repayments on long-term revolving credit facility		(7.7)
Net borrowings/(repayments) on working capital revolving credit facility	(125.6)	55.3
Net borrowings/(repayments) on short-term letters of credit and hedged inventory facility	(417.5)	559.5
Proceeds from issuance of senior notes		249.5
Net proceeds from the issuance of common units (Note 7)	382.5	315.6
Distributions paid to common unitholders (Note 7)	(272.7)	(164.0)
Distributions paid to general partner (Note 7)	(57.5)	(25.4)



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Other financing activities	(0.5)	(6.6)
Net cash provided by (used in) financing activities	(491.3)	976.2
Effect of translation adjustment on cash	8.2	0.7
Net increase in cash and cash equivalents	1.2	0.7
Cash and cash equivalents, beginning of period	11.3	9.6
Cash and cash equivalents, end of period	\$ 12.5	\$ 10.3
Cash paid for interest, net of amounts capitalized	\$ 146.1	\$ 74.3
Cash paid for income taxes	\$ 2.6	\$

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

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**PLAINS ALL AMERICAN PIPELINE, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF PARTNERS CAPITAL**  
(in millions)

	Common Units		General Partner	Total Partners
	Units	Amount	Amount	Capital Amount
Balance at December 31, 2006	109.4	\$ 2,906.1	\$ 70.7	\$ 2,976.8
Net income		231.3	56.6	287.9
Distributions		(272.7)	(57.5)	(330.2)
Issuance of common units	6.3	374.8	7.7	382.5
Issuance of common units under Long-Term Incentive Plans ( LTIP )	0.3	17.2	0.4	17.6
Capital contribution from General Partner Class B Units (non-cash)			0.6	0.6
Other comprehensive income		86.2	1.8	88.0
Balance at September 30, 2007	116.0	\$ 3,342.9	\$ 80.3	\$ 3,423.2

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(in millions)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Net income	\$ 98.4	\$ 95.4	\$ 287.9	\$ 239.1
Other comprehensive income	42.8	123.8	88.0	143.4
Comprehensive income	\$ 141.2	\$ 219.2	\$ 375.9	\$ 382.5

**CONDENSED CONSOLIDATED STATEMENT OF**  
**CHANGES IN ACCUMULATED OTHER COMPREHENSIVE INCOME**  
(in millions)

	Net Deferred Gain/(Loss) on Derivative	Currency Translation

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	<b>Instruments</b>	<b>Adjustments</b> (unaudited)	<b>Total</b>
Balance at December 31, 2006	\$ (19.8)	\$ 69.5	\$ 49.7
Current Period Activity:			
Reclassification adjustments for settled contracts	(14.1)		(14.1)
Changes in fair value of outstanding hedge positions	(1.5)		(1.5)
Currency translation adjustment		103.6	103.6
Total period activity	(15.6)	103.6	88.0
Balance at September 30, 2007	\$ (35.4)	\$ 173.1	\$ 137.7

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

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**PLAINS ALL AMERICAN PIPELINE, L.P. AND SUBSIDIARIES**  
**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**Note 1 Organization and Accounting Policies**

As used in this Form 10-Q and unless the context indicates otherwise, the terms Partnership, Plains, we, us, ours and similar terms refer to Plains All American Pipeline, L.P. and its subsidiaries. We are engaged in the transportation, storage, terminalling and marketing of crude oil, refined products and liquefied petroleum gas and other natural gas-related petroleum products. We refer to liquefied petroleum gas and other natural gas-related petroleum products collectively as LPG. Through our 50% equity ownership in PAA/Vulcan Gas Storage, LLC ( PAA/Vulcan ), we are also engaged in the development and operation of natural gas storage facilities.

Our condensed consolidated interim financial statements should be read in conjunction with our consolidated financial statements and notes thereto presented in our 2006 Annual Report on Form 10-K. The financial statements have been prepared in accordance with the instructions for interim reporting as prescribed by the Securities and Exchange Commission. All adjustments (consisting only of normal recurring adjustments) that in the opinion of management were necessary for a fair statement of the results for the interim periods have been reflected. All significant intercompany transactions have been eliminated. Certain reclassifications are made to prior periods to conform to current period presentation. The results of operations for the three months and nine months ended September 30, 2007 should not be taken as indicative of the results to be expected for the full year.

The accompanying condensed consolidated financial statements of PAA include PAA and all of its wholly-owned subsidiaries. Investments in 50% or less owned entities over which we have significant influence but not control are accounted for by the equity method.

**Note 2 Trade Accounts Receivable**

Our accounts receivable are primarily from purchasers and shippers of crude oil and, to a lesser extent, purchasers of LPG and refined products. The majority of our accounts receivable relate to our marketing activities, which are generally high volume and low margin activities, in many cases involving exchanges of crude oil volumes. We determine the amount, if any, of the line of credit to be extended to any given customer and the form and amount of financial performance assurances we require. Such financial assurances are commonly provided to us in the form of standby letters of credit, advance cash payments or parental guarantees. At September 30, 2007 and December 31, 2006, we had received approximately \$24 million and \$28 million, respectively, of advance cash payments and prepayments from third parties to mitigate credit risk. In addition, we enter into netting arrangements with our counterparties. These arrangements cover a significant part of our transactions and also serve to mitigate credit risk.

We review all outstanding accounts receivable balances on a monthly basis and record a reserve for amounts that we expect will not be fully recovered. Actual balances are not applied against the reserve until substantially all collection efforts have been exhausted. At September 30, 2007 and December 31, 2006, substantially all of our net accounts receivable were less than 60 days past their scheduled invoice date. Although we consider our allowance for doubtful trade accounts receivable to be adequate, actual amounts may vary significantly from estimated amounts.

**Note 3 Acquisitions and Dispositions**

During the first nine months of 2007, we acquired (i) a commercial refined products supply and marketing business (reflected in our marketing segment) for approximately \$8 million in cash (including approximately \$7 million of goodwill), (ii) a trucking business (reflected in our transportation segment) for approximately \$9 million in cash (including approximately \$4 million of goodwill) and (iii) the Bumstead LPG storage facility located near Phoenix, Arizona (reflected in our facilities segment) for

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approximately \$52 million in cash (there was no goodwill associated with this acquisition). The Bumstead facility has a working capacity of approximately 3.2 million barrels of LPG. Also, during the third quarter of 2007, we signed an agreement to acquire the Tirzah LPG storage facility and other assets located near York County, South Carolina for approximately \$54 million. The acquisition closed on October 2, 2007 and will be reflected in our facilities segment in the fourth quarter of 2007. The Tirzah facility has a working capacity of approximately 1.4 million barrels.

Certain adjustments related to the purchase price for the acquisition of Pacific Energy Partners, L. P. ( Pacific ) have been recorded in the first nine months of 2007, resulting in increased goodwill. The purchase price allocations related to the Pacific, Bumstead and Tirzah acquisitions are preliminary and subject to change, pending finalization of the valuation of the assets and liabilities acquired.

In the first nine months of 2007, we incurred a net loss of approximately \$8 million upon the disposition of certain inactive assets. This loss is included within Depreciation and Amortization in our Condensed Consolidated Statements of Operations.

**Note 4 Inventory and Linefill**

At September 30, 2007 and December 31, 2006, inventory and linefill consisted of:

	September 30, 2007			December 31, 2006		
	Barrels	Dollars	Dollar/ barrel (2)	Barrels	Dollars	Dollar/ barrel (2)
	(Barrels in thousands and dollars in millions)					
<b>Inventory<sup>(1)</sup></b>						
Crude oil	7,527	\$ 508.1	\$ 67.50	18,331	\$ 1,029.1	\$ 56.14
LPG	8,673	441.0	\$ 50.85	5,818	250.7	\$ 43.09
Refined Products	94	7.2	\$ 76.60	81	3.8	\$ 46.91
Parts and supplies	N/A	8.6	N/A	N/A	6.4	N/A
Inventory subtotal	16,294	964.9				

ty 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, 2008	December 31, 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.

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

	September 30, 2008	December 31, 2007	September 30, 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
Total non-accrual loans	46,579	21,385	8,690
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
Total other repossessed assets	5,817	2,716	590
Total non-performing assets	\$55,366	\$28,248	\$ 13,636

(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 30, 2008	December 31, 2007	September 30, 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, 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 September 30, 2008			For the three months ended September 30, 2007		
	Average Balance	Revenue/ Expense <sup>(1)</sup>	Yield/ Rate	Average Balance	Revenue/ Expense <sup>(1)</sup>	Yield/ 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 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 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 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 branches	720,211	4,321	2.39%	1,037,813	13,181	5.04%
Total interest bearing 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 subordinated debentures	113,406	1,486	5.21%	113,406	2,088	7.30%
Total interest bearing 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 September 30, 2008			For the nine months ended September 30, 2007		
	Average Balance	Revenue/ Expense <sup>(1)</sup>	Yield/ Rate	Average Balance	Revenue/ Expense <sup>(1)</sup>	Yield/ 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 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 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 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 branches	810,472	17,585	2.90%	973,692	37,145	5.10%
Total interest bearing 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 subordinated debentures	113,406	4,837	5.70%	113,406	6,198	7.31%
Total interest bearing 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 September 30, 2008/2007			Nine months ended 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
<b>Total non-interest income</b>	<b>\$4,885</b>	<b>\$4,875</b>	<b>\$16,520</b>	<b>\$15,747</b>

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, 2008	December 31, 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 ended September 30, 2008	Nine months ended September 30, 2007	Year ended December 31, 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.

**Table of Contents****Non-performing Assets**

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 30, 2008	December 31, 2007	September 30, 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 One Year	After One but Within Three Years	After Three but Within Five Years	After Five Years	Total
Deposits without a stated maturity (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 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 Balance	4-12 mo Balance	1-3 yr Balance	3+ yr Balance	Total 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 funds purchased, FHLB borrowings	835,025				835,025
Trust preferred subordinated 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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