

TEXAS CAPITAL BANCSHARES INC/TX

Form 10-Q

October 31, 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**

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 0-30533**

**TEXAS CAPITAL BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**75-2679109**

(I.R.S. Employer Identification Number)

**2100 McKinney Avenue, Suite 900, Dallas, Texas,  
U.S.A.**

(Address of principal executive officers)

**75201**

(Zip Code)

**214/932-6600**

(Registrant's telephone number, including area code)

**N/A**

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

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

On October 30, 2007, the number of shares set forth below was outstanding with respect to each of the issuer's classes of common stock:

Common Stock, par value \$0.01 per share

26,265,299

Texas Capital Bancshares, Inc.  
Form 10-Q  
Quarter Ended September 30, 2007  
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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****TEXAS CAPITAL BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS UNAUDITED**

(In thousands except per share data)

|  | Three months ended<br>September 30 |               | Nine months ended<br>September 30 |               |
|--|------------------------------------|---------------|-----------------------------------|---------------|
|  | 2007                               | 2006          | 2007                              | 2006          |
| <b>Interest income</b>                                     |                                    |               |                                   |               |
| Interest and fees on loans                                 | \$70,719                           | \$56,320      | \$198,419                         | \$150,812     |
| Securities   | 5,623                              | 6,488         | 17,460                            | 20,045        |
| Federal funds sold   | 12                                 | 24            | 27                                | 51            |
| Deposits in other banks                                    | 14                                 | 16            | 44                                | 40            |
| Total interest income                                      | 76,368                             | 62,848        | 215,950                           | 170,948       |
| <b>Interest expense</b>                                    |                                    |               |                                   |               |
| Deposits   | 32,690                             | 28,337        | 93,311                            | 70,013        |
| Federal funds purchased                                    | 3,554                              | 1,753         | 9,474                             | 6,094         |
| Repurchase agreements                                      | 175                                | 665           | 839                               | 3,429         |
| Other borrowings   | 1,102                              | 634           | 3,231                             | 2,078         |
| Trust preferred subordinated debentures                    | 2,088                              | 1,358         | 6,198                             | 3,353         |
| Total interest expense                                     | 39,609                             | 32,747        | 113,053                           | 84,967        |
| <b>Net interest income</b>                                 | <b>36,759</b>                      | <b>30,101</b> | <b>102,897</b>                    | <b>85,981</b> |
| <b>Provision for loan losses</b>                           | <b>2,000</b>                       | <b>750</b>    | <b>4,700</b>                      | <b>3,000</b>  |
| <b>Net interest income after provision for loan losses</b> | <b>34,759</b>                      | <b>29,351</b> | <b>98,197</b>                     | <b>82,981</b> |
| <b>Non-interest income</b>                                 |                                    |               |                                   |               |
| Service charges on deposit accounts                        | 1,089                              | 780           | 2,935                             | 2,441         |
| Trust fee income   | 1,182                              | 1,008         | 3,453                             | 2,717         |
| Bank owned life insurance (BOLI) income                    | 288                                | 255           | 887                               | 833           |
| Brokered loan fees   | 452                                | 656           | 1,505                             | 1,508         |
| Equipment rental income                                    | 1,581                              | 1,147         | 4,533                             | 2,475         |
| Other  | 55                                 | 632           | 1,758                             | 2,234         |
| Total non-interest income                                  | 4,647                              | 4,478         | 15,071                            | 12,208        |
| <b>Non-interest expense</b>                                |                                    |               |                                   |               |
| Salaries and employee benefits                             | 15,254                             | 12,542        | 44,573                            | 36,871        |
| Net occupancy expense                                      | 2,194                              | 1,907         | 6,269                             | 5,872         |
| Leased equipment depreciation                              | 1,311                              | 928           | 3,722                             | 2,095         |
| Marketing  | 669                                | 690           | 2,154                             | 2,298         |
| Legal and professional                                     | 1,799                              | 1,590         | 5,202                             | 4,402         |
| Communications and data processing                         | 849                                | 843           | 2,519                             | 2,268         |
| Franchise taxes  | 46                                 | 58            | 176                               | 223           |
| Other  | 3,772                              | 3,077         | 10,785                            | 8,890         |

|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| Total non-interest expense                                   | 25,894   | 21,635   | 75,400    | 62,919    |
| <b>Income from continuing operations before income taxes</b> | 13,512   | 12,194   | 37,868    | 32,270    |
| Income tax expense   | 4,668    | 4,157    | 13,053    | 11,003    |
| <b>Income from continuing operations</b>                     | 8,844    | 8,037    | 24,815    | 21,267    |
| <b>Loss from discontinued operations (after-tax)</b>         | (602)    | (167)    | (746)     | (413)     |
| <b>Net income</b>  | \$ 8,242 | \$ 7,870 | \$ 24,069 | \$ 20,854 |
| <b>Basic earnings per share:</b>                             |          |          |           |           |
| Income from continuing operations                            | \$ .34   | \$ .31   | \$ .95    | \$ .82    |
| Net income   | \$ .31   | \$ .30   | \$ .92    | \$ .80    |
| <b>Diluted earnings per share:</b>                           |          |          |           |           |
| Income from continuing operations                            | \$ .33   | \$ .30   | \$ .93    | \$ .80    |
| Net income   | \$ .31   | \$ .30   | \$ .90    | \$ .79    |

See accompanying notes to consolidated financial statements.

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

(In thousands except per share data)

|  | September 30,<br>2007<br>(Unaudited) | December 31,<br>2006 |
|--|--------------------------------------|----------------------|
| <b>Assets</b>  |                                      |                      |
| Cash and due from banks  | \$ 75,724                            | \$ 93,716            |
| Securities, available-for-sale   | 476,448                              | 532,053              |
| Loans held for sale  | 118,221                              | 199,014              |
| Loans held for sale from discontinued operations   | 863                                  | 16,844               |
| Loans held for investment (net of unearned income)   | 3,296,039                            | 2,722,097            |
| Less: Allowance for loan losses  | 26,003                               | 21,003               |
| Loans held for investment, net   | 3,270,036                            | 2,701,094            |
| Premises and equipment, net  | 42,224                               | 33,818               |
| Accrued interest receivable and other assets   | 86,746                               | 85,821               |
| Goodwill and intangible assets, net  | 7,891                                | 12,989               |
| Total assets   | \$4,078,153                          | \$3,675,349          |
| <b>Liabilities and Stockholders Equity</b>   |                                      |                      |
| Liabilities:   |                                      |                      |
| Deposits:  |                                      |                      |
| Non-interest bearing   | \$ 471,109                           | \$ 513,930           |
| Interest bearing   | 1,788,809                            | 1,670,956            |
| Interest bearing in foreign branches   | 1,035,789                            | 884,444              |
| Total deposits   | 3,295,707                            | 3,069,330            |
| Accrued interest payable   | 7,312                                | 5,781                |
| Other liabilities  | 19,009                               | 21,758               |
| Federal funds purchased  | 216,744                              | 165,955              |
| Repurchase agreements  | 7,820                                | 43,359               |
| Other borrowings   | 133,946                              | 2,245                |
| Trust preferred subordinated debentures  | 113,406                              | 113,406              |
| Total liabilities  | 3,793,944                            | 3,421,834            |
| Stockholders equity:   |                                      |                      |
| Common stock, \$.01 par value:   |                                      |                      |
| Authorized shares 100,000,000  |                                      |                      |
| Issued shares 26,243,149 and 26,065,124 at September 30, 2007 and<br>December 31, 2006, respectively | 263                                  | 261                  |
| Additional paid-in capital   | 188,265                              | 182,321              |
| Retained earnings  | 100,232                              | 76,163               |
|  | (581)                                | (573)                |

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Treasury stock (shares at cost: 84,691 and 84,274 at September 30, 2007  
and December 31, 2006)

|  |             |             |
|--|-------------|-------------|
| Deferred compensation                              | 573         | 573         |
| Accumulated other comprehensive loss, net of taxes | (4,543)     | (5,230)     |
| Total stockholders' equity                         | 284,209     | 253,515     |
| Total liabilities and stockholders' equity         | \$4,078,153 | \$3,675,349 |

See accompanying notes to consolidated financial statements.

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

(In thousands except share data)

|   | Common Stock |        | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Treasury Stock |         | Deferred<br>Compensation | Accumulated<br>Other<br>Comprehensive | Total     |
|---|--------------|--------|----------------------------------|----------------------|----------------|---------|--------------------------|---------------------------------------|-----------|
|   | Shares       | Amount |                                  |                      | Shares         | Amount  |                          | Loss                                  |           |
| Balance at<br>December 31,<br>2005  | 25,771,718   | \$258  | \$176,131                        | \$ 47,239            | (84,274)       | \$(573) | \$ 573                   | \$(8,105)                             | \$215,523 |
| Comprehensive<br>income:  |              |        |                                  |                      |                |         |                          |                                       |           |
| Net income  |              |        |                                  | 28,924               |                |         |                          |                                       | 28,924    |
| Change in<br>unrealized gain<br>(loss) on<br>available-for-sale<br>securities, net of<br>taxes of \$1,547 |              |        |                                  |                      |                |         |                          | 2,875                                 | 2,875     |
| Total<br>comprehensive<br>income  |              |        |                                  |                      |                |         |                          |                                       | 31,799    |
| Tax benefit<br>related to exercise<br>of stock options  |              |        | 1,431                            |                      |                |         |                          |                                       | 1,431     |
| Stock-based<br>compensation<br>expense<br>recognized in<br>earnings                                       |              |        | 2,847                            |                      |                |         |                          |                                       | 2,847     |
| Issuance of<br>common stock   | 293,406      | 3      | 1,912                            |                      |                |         |                          |                                       | 1,915     |
| Balance at<br>December 31,<br>2006  | 26,065,124   | 261    | 182,321                          | 76,163               | (84,274)       | (573)   | 573                      | (5,230)                               | 253,515   |
| Comprehensive<br>income:  |              |        |                                  |                      |                |         |                          |                                       |           |
| Net income<br>(unaudited)   |              |        |                                  | 24,069               |                |         |                          |                                       | 24,069    |
| Change in<br>unrealized gain<br>(loss) on<br>available-for-sale<br>securities, net of                     |              |        |                                  |                      |                |         |                          | 687                                   | 687       |



|  |            |       |           |           |          |         |       |           |           |        |
|--|------------|-------|-----------|-----------|----------|---------|-------|-----------|-----------|--------|
| taxes of \$370<br>(unaudited)  |            |       |           |           |          |         |       |           |           |        |
| Total<br>comprehensive<br>income<br>(unaudited)                                    |            |       |           |           |          |         |       |           |           | 24,756 |
| Tax benefit<br>related to exercise<br>of stock options<br>(unaudited)              |            |       | 704       |           |          |         |       |           |           | 704    |
| Stock-based<br>compensation<br>expense<br>recognized in<br>earnings<br>(unaudited) |            |       | 3,809     |           |          |         |       |           |           | 3,809  |
| Issuance of stock<br>related to<br>stock-based<br>awards<br>(unaudited)            | 178,025    | 2     | 1,431     |           |          |         |       |           |           | 1,433  |
| Purchase of<br>treasury stock<br>(unaudited)                                       |            |       |           |           | (417)    | (8)     |       |           |           | (8)    |
| Balance at<br>September 30,<br>2007 (unaudited)                                    | 26,243,149 | \$263 | \$188,265 | \$100,232 | (84,691) | \$(581) | \$573 | \$(4,543) | \$284,209 |        |

See accompanying notes to consolidated financial statements.

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

(In thousands)

|   | Nine months ended<br>September 30 |             |
|---|-----------------------------------|-------------|
|   | 2007                              | 2006        |
| <b>Operating activities</b>   |                                   |             |
| Net income  | \$ 24,069                         | \$ 20,854   |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                                   |             |
| Provision for loan losses   | 4,700                             | 3,000       |
| Depreciation and amortization   | 5,436                             | 4,057       |
| Amortization and accretion on securities  | 247                               | 826         |
| Bank owned life insurance (BOLI) income   | (887)                             | (833)       |
| Stock-based compensation expense  | 3,809                             | 2,200       |
| Tax benefit from stock option exercises   | 704                               | 1,323       |
| Excess tax benefits from stock-based compensation arrangements                              | (2,010)                           | (3,780)     |
| Originations of loans held for sale   | (3,080,942)                       | (2,151,289) |
| Proceeds from sales of loans held for sale  | 3,151,025                         | 2,072,417   |
| Changes in operating assets and liabilities:  |                                   |             |
| Accrued interest receivable and other assets  | (38)                              | (4,556)     |
| Accrued interest payable and other liabilities  | (1,587)                           | 2,767       |
| Net cash (used in) provided by operating activities of continuing operations                | 104,526                           | (53,014)    |
| Net cash provided by operating activities of discontinued operations                        | 20,835                            | 8,083       |
| Net cash (used in) provided by operating activities   | 125,361                           | (44,931)    |
| <b>Investing activities</b>   |                                   |             |
| Purchases of available-for-sale securities  | (24,423)                          | (11,851)    |
| Maturities and calls of available-for-sale securities                                       | 19,438                            | 12,800      |
| Principal payments received on securities   | 61,399                            | 74,784      |
| Net increase in loans held for investment   | (561,706)                         | (466,395)   |
| Purchase of premises and equipment, net   | (14,824)                          | (15,451)    |
| Net cash used in investing activities of continuing operations                              | (520,116)                         | (406,113)   |
| Net cash used in investing activities of discontinued operations                            |                                   | (242)       |
| Net cash used in investing activities   | (520,116)                         | (406,355)   |
| <b>Financing activities</b>   |                                   |             |
| Net increase in deposits  | 226,377                           | 281,469     |
| Issuance of stock related to stock-based awards   | 1,433                             | 1,566       |
| Issuance of trust preferred subordinated debentures   |                                   | 67,012      |
| Net increase (decrease) in other borrowings   | 96,162                            | (5,203)     |
| Excess tax benefits from stock-based compensation arrangements                              | 2,010                             | 3,780       |

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|  |            |            |
|--|------------|------------|
| Net federal funds purchased  | 50,789     | 78,283     |
| Purchase of treasury stock   | (8)        |            |
| Net cash provided by financing activities of continuing operations   | 376,763    | 426,907    |
| Net cash provided by financing activities of discontinued operations |            |            |
| Net cash provided by financing activities                            | 376,763    | 426,907    |
| Net decrease in cash and cash equivalents                            | (17,992)   | (24,379)   |
| Cash and cash equivalents at beginning of period                     | 93,716     | 137,840    |
| Cash and cash equivalents at end of period                           | \$ 75,724  | \$ 113,461 |
| Supplemental disclosures of cash flow information:                   |            |            |
| Cash paid during the period for interest                             | \$ 111,522 | \$ 85,500  |
| Cash paid during the period for income taxes                         | 13,302     | 10,207     |
| Non-cash transactions:   |            |            |
| Transfers from loans/leases to premises and equipment                | 1,084      | 1,945      |
| Transfers from loans held for sale to loans held for investment      | 10,159     |            |
| See accompanying notes to consolidated financial statements.         |            |            |

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**TEXAS CAPITAL BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED**

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

**Nature of Operations**

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

**Basis of Presentation**

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

The consolidated interim financial statements have been prepared without audit. Certain information and footnote disclosures presented in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, the interim financial statements include all normal and recurring adjustments and the disclosures made are adequate to make interim financial information not misleading. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission (SEC). Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with our consolidated financial statements, and notes thereto, for the year ended December 31, 2006, included in our Annual Report on Form 10-K filed with the SEC on March 2, 2007 (the 2006 Form 10-K ). Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

**Use of Estimates**

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

**Loans**

Loans (which include equipment leases accounted for as financing leases) are stated at the amount of unpaid principal reduced by deferred income (net of costs) and an allowance for loan losses. Interest on loans is recognized using the simple-interest method on the daily balances of the principal amounts outstanding. Loan origination fees, net of direct loan origination costs, and commitment fees, are deferred and amortized as an adjustment to yield over the life of the loan, or over the commitment period, as applicable.

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 expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral.

The accrual of interest on loans is discontinued when it is considered impaired and/or 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

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unpaid interest is reversed. Interest income is subsequently recognized on a cash basis as long as the remaining book balance of the asset is deemed to be collectible. If collectibility is questionable, then cash payments are applied to principal. A loan is placed back on accrual status when both principal and interest are current and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement. We purchase participations in mortgage loans primarily for sale in the secondary market through our mortgage warehouse division. Accordingly, these loans are classified as held for sale and are carried at the lower of cost or fair value, determined on an aggregate basis. As a result of dislocations in the mortgage industry, some loan participations may not be sold within the normal timeframes or at previously negotiated prices. Earnings contribution from the mortgage warehouse business has been affected by reduced volumes and mark to market, and due to uncertain market conditions, future results from the mortgage warehouse division could be subject to wider fluctuations. Due to market conditions, certain mortgage warehouse loans have been transferred to our loans held for investment portfolio, and such loans are transferred at a lower of cost or market. Mortgage warehouse loans transferred to our loans held for investment portfolio could require significant allocations of the allowance for loan losses or be subject to charge off in the event the loans become impaired.

**Allowance for Loan Losses**

The allowance for loan losses is established through a provision for loan losses charged against income. The allowance for loan losses includes specific reserves for impaired loans and an estimate of losses inherent in the loan portfolio at the balance sheet date, but not yet identified with specific loans. Loans deemed to be uncollectible are charged against the allowance when management believes that the collectibility of the principal is unlikely and subsequent recoveries, if any, are credited to the allowance. Management's periodic evaluation of the adequacy of the allowance is based on an assessment of the current loan portfolio, including known inherent risks, adverse situations that may affect the borrowers' ability to repay, the estimated value of any underlying collateral and current economic conditions.

**Stock-based Compensation**

On January 1, 2006, we changed our accounting policy related to stock-based compensation in connection with the adoption of Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment (Revised 2004) (SFAS 123R). Prior to adoption, we accounted for stock plans under the recognition and measurement principles of APB Opinion 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations. No stock-based compensation was reflected in net income, as all option grants had an exercise price equal to the market value of the underlying common stock on the date of the grant. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation expense in the statement of operations based on their fair values on the measurement date, which is the date of the grant. We transitioned to fair value based accounting for stock-based compensation using a modified version of prospective application (modified prospective application). Under modified prospective application, as it is applicable to us, SFAS 123R applies to new awards and to awards modified, repurchased or cancelled after January 1, 2006. Additionally, compensation expense for the portion of awards for which the requisite period has not been rendered (generally referring to nonvested awards) that were outstanding as of January 1, 2006 are recognized as the remaining requisite service is rendered during and after the period of adoption of SFAS 123R. The compensation expense for the earlier awards is based on the same method and on the same grant date fair values previously determined for the pro forma disclosures required for all companies that did not previously adopt the fair value accounting method for stock-based compensation.

**Income Taxes**

On January 1, 2007, we changed our accounting policy related to accounting for tax contingencies in connection with the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement 109 (Interpretation 48). See Note 10 New Accounting Pronouncements for additional information.

**Accumulated Other Comprehensive Income (Loss)**

Unrealized gains or losses on our available-for-sale securities (after applicable income tax expense or benefit)



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are included in accumulated other comprehensive income (loss).

**(2) EARNINGS PER SHARE**

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

|  | Three months ended<br>September 30 |            | Nine months ended<br>September 30 |            |
|--|------------------------------------|------------|-----------------------------------|------------|
|  | 2007                               | 2006       | 2007                              | 2006       |
| Numerator:   |                                    |            |                                   |            |
| Net income from continuing operations  | \$ 8,844                           | \$ 8,037   | \$ 24,815                         | \$ 21,267  |
| Loss from discontinued operations  | (602)                              | (167)      | (746)                             | (413)      |
| Net income   | \$ 8,242                           | \$ 7,870   | \$ 24,069                         | \$ 20,854  |
| Denominator:   |                                    |            |                                   |            |
| Denominator for basic earnings per<br>share-weighted average shares  | 26,212,494                         | 25,998,071 | 26,148,778                        | 25,910,855 |
| Effect of employee stock options <sup>(1)</sup>  | 554,294                            | 413,763    | 492,011                           | 590,000    |
| Denominator for dilutive earnings per<br>share-adjusted weighted average shares<br>and assumed conversions | 26,766,788                         | 26,411,834 | 26,640,789                        | 26,500,855 |
| Basic earnings per share from<br>continuing operations   | \$ .34                             | \$ .31     | \$ .95                            | \$ .82     |
| Basic earnings per share from<br>discontinued operations   | (.03)                              | (.01)      | (.03)                             | (.02)      |
| Basic earnings per share   | \$ .31                             | \$ .30     | \$ .92                            | \$ .80     |
| Diluted earnings per share from<br>continuing operations   | \$ .33                             | \$ .30     | \$ .93                            | \$ .80     |
| Diluted earnings per share from<br>discontinued operations   | (.02)                              |            | (.03)                             | (.01)      |
| Diluted earnings per share   | \$ .31                             | \$ .30     | \$ .90                            | \$ .79     |

(1) Stock options  
outstanding of  
817,170 at  
September 30,  
2007 and  
882,170  
September 30,

2006 have not been included in diluted earnings per share because to do so would have been anti-dilutive for the periods presented. Stock options are anti-dilutive when the exercise price is higher than the average market price of our common stock.



**Table of Contents****(3) LOANS AND ALLOWANCE FOR LOAN LOSSES**

At September 30, 2007 and December 31, 2006, loans were as follows (in thousands):

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| Commercial  | \$1,942,867           | \$1,602,577          |
| Construction                                      | 583,843               | 538,586              |
| Real estate                                       | 708,560               | 530,377              |
| Consumer  | 22,942                | 21,113               |
| Leases  | 57,155                | 45,280               |
| Gross loans held for investment                   | 3,315,367             | 2,737,933            |
| Deferred income (net of direct origination costs) | (19,328)              | (15,836)             |
| Allowance for loan losses                         | (26,003)              | (21,003)             |
| Total loans held for investment, net              | 3,270,036             | 2,701,094            |
| Loans held for sale                               | 118,221               | 199,014              |
| Loans held for sale from discontinued operations  | 863                   | 16,844               |
| Total loans, net                                  | \$3,389,120           | \$2,916,952          |

We continue to lend primarily in Texas. As of September 30, 2007, 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.

**Non-Performing Assets**

Non-performing loans and leases at September 30, 2007, December 31, 2006 and September 30, 2006 are summarized as follows (in thousands):

|   | September<br>30,<br>2007 | December<br>31,<br>2006 | September<br>30,<br>2006 |
|---|--------------------------|-------------------------|--------------------------|
| Non-accrual loans: <sup>(1)</sup> <sup>(3)</sup>                  |                          |                         |                          |
| Commercial  | \$ 2,601                 | \$ 5,587                | \$ 2,879                 |
| Construction  | 4,952                    |                         |                          |
| Real estate   | 1,118                    | 3,417                   | 3,460                    |
| Consumer  | 12                       | 63                      | 63                       |
| Equipment leases  | 7                        | 21                      | 30                       |
| Total non-accrual loans   | 8,690                    | 9,088                   | 6,432                    |
| Loans past due 90 days and accruing <sup>(2)</sup> <sup>(3)</sup> | 4,356                    | 2,142                   | 2,627                    |
| Other repossessed assets:   |                          |                         |                          |
| Other real estate owned <sup>(3)</sup>                            | 501                      | 882                     | 882                      |
| Other repossessed assets  | 89                       | 135                     | 90                       |

|                                |          |          |          |
|--------------------------------|----------|----------|----------|
| Total other repossessed assets | 590      | 1,017    | 972      |
| Total non-performing assets    | \$13,636 | \$12,247 | \$10,031 |

(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 collectibility is questionable, then cash payments are applied to principal.

(2) At September 30, 2007, \$1.3 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. The total also includes \$274,000 of loans fully guaranteed by the U.S. Department of Agriculture.

- (3) At September 30, 2007, non-performing assets include \$2.4 million of mortgage warehouse loans that were transferred from loans held for sale to loans held for investment at lower of cost or market.

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

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

|  | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2007                                | 2006     | 2007                               | 2006     |
| Balance at the beginning of the period | \$24,062                            | \$19,646 | \$21,003                           | \$18,897 |
| Provision for loan losses              | 2,000                               | 750      | 4,700                              | 3,000    |
| Net charge-offs:                       |                                     |          |                                    |          |
| Loans charged-off                      | 155                                 | 70       | 455                                | 1,731    |
| Recoveries                             | 96                                  | 515      | 755                                | 675      |
| Net charge-offs (recoveries)           | 59                                  | (445)    | (300)                              | 1,056    |
| Balance at the end of the period       | \$26,003                            | \$20,841 | \$26,003                           | \$20,841 |

**(4) 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, 2007, December 31, 2006 and September 30, 2006 are summarized as follows (in thousands):

|                                   | September<br>30,<br>2007 | December 31,<br>2006 | September<br>30,<br>2006 |
|-----------------------------------|--------------------------|----------------------|--------------------------|
| Premises                          | \$ 6,089                 | \$ 5,876             | \$ 5,797                 |
| Furniture and equipment           | 12,975                   | 12,758               | 11,907                   |
| Rental equipment <sup>(1)</sup>   | 42,688                   | 30,241               | 27,107                   |
|                                   | 61,752                   | 48,875               | 44,811                   |
| Accumulated depreciation          | (19,528)                 | (15,057)             | (13,206)                 |
| Total premises and equipment, net | \$ 42,224                | \$ 33,818            | \$ 31,605                |

(1) These assets represent the assets related to operating leases.

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

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

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

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

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

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|   |                       |
|---|-----------------------|
| (In thousands)  | September 30,<br>2007 |
| Financial instruments whose contract amounts represent credit risk: |                       |
| Commitments to extend credit  | \$1,247,257           |
| Standby letters of credit   | 55,977                |

**(6) 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 Security Act (BSA) 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. Consequently, the Company and the Bank will continue to undertake programs designed to ensure compliance with applicable laws and regulations.

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, 2007, 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 tables below. As shown below, the Bank's capital ratios exceed the regulatory definition of well capitalized as of September 30, 2007 and 2006. As of March 31, 2006, 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 information in our most recently filed call report and 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.

**TABLE 6 CAPITAL RATIOS**

|                     | September<br>30,<br>2007 | September<br>30,<br>2006 |
|---------------------|--------------------------|--------------------------|
| Risk-based capital: |                          |                          |
| Tier I capital      | 9.59%                    | 11.12%                   |
| Total capital       | 10.67%                   | 11.79%                   |
| Leverage            | 9.37%                    | 10.16%                   |

**(7) STOCK-BASED COMPENSATION**

The fair value of our stock option and 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 different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate,



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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 SFAS 123R during the three and nine months ended September 30, 2007, we recognized stock-based compensation expense of \$1.3 million, or \$851,000 net of tax, and \$3.8 million, or \$2.5 million net of tax. Stock-based compensation expense related to stock options represents \$0.03 and \$0.09 in diluted earnings per share during the three and nine months ended September 30, 2007, respectively. The amount for the three months ended September 30, 2007 is comprised of \$342,000 related to unvested options issued prior to the adoption of SFAS 123R, \$423,000 related to SARs issued in 2006 and 2007, and \$535,000 related to RSUs issued in 2006 and 2007. The amount for the nine months ended September 30, 2007 is comprised of \$1,059,000 related to unvested options issued prior to the adoption of SFAS 123R, \$1,219,000 related to SARs issued during 2006 and 2007, and \$1,530,000 related to RSUs issued in 2006 and 2007. Cash flows from financing activities for the nine months ended September 30, 2007 included \$2.0 million in cash inflows from excess tax benefits related to stock compensation. Such cash flows were previously reported as operating activities. Unrecognized stock-based compensation expense related to unvested options issued prior to adoption of SFAS 123R is \$2.3 million, pre-tax. At September 30, 2007, the weighted average period over which this unrecognized expense is expected to be recognized was 1.6 years. Unrecognized stock-based compensation expense related to grants during 2006 and 2007 is \$14.3 million. At September 30, 2007, the weighted average period over which this unrecognized expense is expected to be recognized was 2.5 years.

**(8) DISCONTINUED OPERATIONS**

On March 30, 2007, we completed the sale of our TexCap Insurance Services (TexCap) subsidiary; the sale is, 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 and schedules. During 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 and schedules.

During the third quarter of 2007, the loss from discontinued operations was \$602,000, net of taxes. The loss is primarily related to an additional \$750,000, or \$491,000 net of taxes, related to mark to market adjustment and additional reserves for potential repurchases. We still have approximately \$863,000 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 results for discontinued operations for the third quarter of 2007 include an estimate of 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.

**(9) SHORT-TERM BORROWINGS**

On September 27, 2007, we entered into a Credit Agreement with KeyBank National Association. This Credit Agreement permits revolving borrowings of up to \$50 million and matures on September 24, 2008. At our option, the unpaid principal balance on the Credit Agreement as of September 24, 2008 may be converted into a two-year term loan, which will accrue interest at the same rate(s) as the revolving loans existing on such date. The Credit Agreement permits multiple borrowings that may bear interest at the prime rate minus 1.25% or the London Interbank Offered Rate (LIBOR) plus 1% at our election. The Credit Agreement is unsecured and proceeds may be used for general corporate purposes. The Credit Agreement contains customary financial covenants and restrictions. At September 30, 2007, we had drawn \$5 million, which is included in our total other borrowings.

**(10) NEW ACCOUNTING PRONOUNCEMENTS**

On January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in



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Income Taxes, an Interpretation of FASB Statement 109. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Adoption of Interpretation 48 did not have a significant impact on our financial statements.

We file income tax returns in the U.S. federal jurisdiction and several U.S. state jurisdictions. We are no longer subject to U.S. Federal income tax examinations by tax authorities for years before 2004.

*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 is not expected to have a significant impact on our financial statements.

*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. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Bank on January 1, 2008 and is not expected to have a significant impact on our financial statements.

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

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

|   | For the three months ended<br>September 30, 2007 |                                    |                | For the three months ended<br>September 30, 2006 |                                    |                |
|---|--|------------------------------------|----------------|--|------------------------------------|----------------|
|   | Average<br>Balance                               | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate | Average<br>Balance                               | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate |
| <b>Assets</b>                                     |  |                                    |                |  |                                    |                |
| Securities taxable                                | \$ 432,595                                       | \$ 5,187                           | 4.76%          | \$ 507,156                                       | \$ 6,055                           | 4.74%          |
| Securities non-taxable <sup>(2)</sup>             | 48,173   | 671                                | 5.53%          | 48,595   | 666                                | 5.44%          |
| Federal funds sold                                | 885  | 12                                 | 5.38%          | 1,750  | 24                                 | 5.44%          |
| Deposits in other banks                           | 1,217  | 14                                 | 4.56%          | 1,498  | 16                                 | 4.24%          |
| Loans held for sale from<br>continuing operations | 150,031  | 2,618                              | 6.92%          | 150,225  | 2,747                              | 7.25%          |
| Loans   | 3,195,480  | 68,101                             | 8.46%          | 2,479,057  | 53,573                             | 8.57%          |
| Less reserve for loan<br>losses                   | 24,065   |                                    |                | 19,823   |                                    |                |
| Loans, net of reserve                             | 3,321,446  | 70,719                             | 8.45%          | 2,609,459  | 56,320                             | 8.56%          |
| Total earning assets                              | 3,804,316  | 76,603                             | 7.99%          | 3,168,458  | 63,081                             | 7.90%          |
| Cash and other assets                             | 188,356  |                                    |                | 217,663  |                                    |                |
| Total assets                                      | \$ 3,992,672                                     |                                    |                | \$ 3,386,121                                     |                                    |                |
| <b>Liabilities and<br/>Stockholders Equity</b>    |  |                                    |                |  |                                    |                |
| Transaction deposits                              | \$ 95,870  | \$ 239                             | 0.99%          | \$ 99,549  | \$ 284                             | 1.13%          |
| Savings deposits                                  | 848,760  | 9,393                              | 4.39%          | 769,271  | 8,703                              | 4.49%          |
| Time deposits                                     | 760,511  | 9,877                              | 5.15%          | 643,708  | 8,069                              | 4.97%          |
| Deposits in foreign<br>branches                   | 1,037,813  | 13,181                             | 5.04%          | 845,338  | 11,281                             | 5.29%          |
| Total interest bearing<br>deposits                | 2,742,954  | 32,690                             | 4.73%          | 2,357,866  | 28,337                             | 4.77%          |
| Other borrowings                                  | 368,824  | 4,831                              | 5.20%          | 238,350  | 3,052                              | 5.08%          |
| Trust preferred<br>subordinated debentures        | 113,406  | 2,088                              | 7.30%          | 73,064   | 1,358                              | 7.37%          |
| Total interest bearing<br>liabilities             | 3,225,184  | 39,609                             | 4.87%          | 2,669,280  | 32,747                             | 4.87%          |
| Demand deposits                                   | 469,610  |                                    |                | 464,645  |                                    |                |
| Other liabilities                                 | 22,173   |                                    |                | 21,633   |                                    |                |
| Stockholders equity                               | 275,705  |                                    |                | 230,563  |                                    |                |
|   | \$ 3,992,672                                     |                                    |                | \$ 3,386,121                                     |                                    |                |

Total liabilities and  
stockholders' equity

|                     |           |       |           |
|---------------------|-----------|-------|-----------|
| Net interest income | \$ 36,994 |       | \$ 30,334 |
| Net interest margin |           | 3.86% | 3.80%     |
| Net interest spread |           | 3.12% | 3.03%     |

(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                 | \$ 1,259 |       | \$ 27,422 |
| Borrowed funds                      | 1,259    |       | 27,422    |
| Net interest income                 |          | \$ 5  | \$ 1,972  |
| Net interest margin<br>consolidated |          |       |           |
|                                     |          | 3.86% | 4.01%     |

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

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

|   | For the nine months ended<br>September 30, 2007 |                                    |                | For the nine months ended<br>September 30, 2006 |                                    |                |
|---|---|------------------------------------|----------------|---|------------------------------------|----------------|
|   | Average<br>Balance                              | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate | Average<br>Balance                              | Revenue/<br>Expense <sup>(1)</sup> | Yield/<br>Rate |
| <b>Assets</b>                                     |   |                                    |                |   |                                    |                |
| Securities taxable                                | \$ 450,517                                      | \$ 16,157                          | 4.79%          | \$ 537,359                                      | \$ 18,742                          | 4.66%          |
| Securities non-taxable <sup>(2)</sup>             | 48,336  | 2,005                              | 5.55%          | 48,615  | 2,004                              | 5.51%          |
| Federal funds sold                                | 692   | 27                                 | 5.22%          | 1,393   | 51                                 | 4.89%          |
| Deposits in other banks                           | 1,193   | 44                                 | 4.93%          | 1,163   | 40                                 | 4.60%          |
| Loans held for sale from<br>continuing operations | 166,113   | 8,849                              | 7.12%          | 108,619   | 5,653                              | 6.96%          |
| Loans   | 2,977,625                                       | 189,570                            | 8.51%          | 2,337,024                                       | 145,159                            | 8.30%          |
| Less reserve for loan<br>losses                   | 22,578  |                                    |                | 19,287  |                                    |                |
| Loans, net of reserve                             | 3,121,160                                       | 198,419                            | 8.50%          | 2,426,356                                       | 150,812                            | 8.31%          |
| Total earning assets                              | 3,621,898                                       | 216,652                            | 8.00%          | 3,014,886                                       | 171,649                            | 7.61%          |
| Cash and other assets                             | 208,102   |                                    |                | 210,764   |                                    |                |
| Total assets                                      | \$ 3,830,000                                    |                                    |                | \$ 3,225,650                                    |                                    |                |
| <b>Liabilities and<br/>Stockholders Equity</b>    |   |                                    |                |   |                                    |                |
| Transaction deposits                              | \$ 98,281                                       | \$ 757                             | 1.03%          | \$ 109,694                                      | \$ 906                             | 1.10%          |
| Savings deposits                                  | 821,751   | 27,360                             | 4.45%          | 714,153   | 22,155                             | 4.15%          |
| Time deposits                                     | 728,446   | 28,049                             | 5.15%          | 654,560   | 22,517                             | 4.60%          |
| Deposits in foreign<br>branches                   | 973,692   | 37,145                             | 5.10%          | 650,663   | 24,435                             | 5.02%          |
| Total interest bearing<br>deposits                | 2,622,170                                       | 93,311                             | 4.76%          | 2,129,070                                       | 70,013                             | 4.40%          |
| Other borrowings                                  | 349,300   | 13,544                             | 5.18%          | 330,877   | 11,601                             | 4.69%          |
| Trust preferred<br>subordinated debentures        | 113,406   | 6,198                              | 7.31%          | 61,424  | 3,353                              | 7.30%          |
| Total interest bearing<br>liabilities             | 3,084,876                                       | 113,053                            | 4.90%          | 2,521,371                                       | 84,967                             | 4.51%          |
| Demand deposits                                   | 455,704   |                                    |                | 459,441   |                                    |                |
| Other liabilities                                 | 23,755  |                                    |                | 20,007  |                                    |                |
| Stockholders equity                               | 265,665   |                                    |                | 224,831   |                                    |                |
|   | \$ 3,830,000                                    |                                    |                | \$ 3,225,650                                    |                                    |                |

Total liabilities and  
stockholders equity

|                     |            |       |           |
|---------------------|------------|-------|-----------|
| Net interest income | \$ 103,599 |       | \$ 86,682 |
| Net interest margin |            | 3.82% | 3.84%     |
| Net interest spread |            | 3.10% | 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                 | \$ 5,788 |        | \$ 30,646 |
| Borrowed funds                      | 5,788    |        | 30,646    |
| Net interest income                 |          | \$ 166 | \$ 5,939  |
| Net interest margin<br>consolidated |          |        | 3.82%     |
|                                     |          |        | 4.07%     |

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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
- (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 (8) Discontinued Operations.

***Summary of Performance***

We reported net income of \$8.2 million, or \$.31 per diluted common share, for the third quarter of 2007 compared to \$7.9 million, or \$.30 per diluted common share, for the third quarter of 2006. We reported net income from continuing operations of \$8.8 million, or \$.33 per diluted common share, for the third quarter of 2007 compared to \$8.0 million, or \$.30 per diluted common share, for the third quarter of 2006. Return on average equity was 11.86% and return on average assets was .82% for the third quarter of 2007, compared to 13.54% and .91%, respectively, for the third quarter of 2006. From continuing operations, return on average equity was 12.73% and return on average assets was .88% for the third quarter of 2007, compared to 13.83% and .94%, respectively, for the third quarter of 2006.

Net interest income for the third quarter of 2007 increased by \$6.7 million, or 22%, to \$36.8 million from \$30.1 million over the third quarter of 2006. The increase in net interest income was due primarily to an increase in average earning assets of \$635.9 million, or 20%, over levels reported in the third quarter of 2006.

Non-interest income increased \$169,000, or 4%, compared to the third quarter of 2006. The increase is primarily related to a \$434,000 increase in rental income on leased equipment from \$1.1 million to \$1.6 million related to expansion of our operating lease portfolio. Service charge income increased \$309,000 due to

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new pricing and trust fee income increased \$174,000 due to continued growth of trust assets. Offsetting these increases was reduced contribution from mortgage warehouse, including brokered loan fees and mark to market. Non-interest expense increased \$4.3 million, or 20%, compared to the third quarter of 2006. The increase is primarily related to a \$2.8 million increase in salaries and employee benefits to \$15.3 million from \$12.5 million, of which \$558,000 relates to an increase in FAS 123R expense. The remaining increase in salaries and employee benefits resulted from growth, including higher level of variable incentives. Expansion of the operating lease portfolio resulted in an increase of \$383,000 in equipment depreciation expense to \$1.3 million from \$928,000 in the third quarter of 2006.

During the third quarter of 2007, the loss from discontinued operations was \$602,000, net of taxes. The loss is primarily related to an additional \$750,000, or \$491,000 net of taxes, related to mark to market adjustment and additional reserves for potential repurchases. We still have approximately \$863,000 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 results for discontinued operations for the third quarter of 2007 include an estimate of 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.

**Net Interest Income**

Net interest income was \$36.8 million for the third quarter of 2007, compared to \$30.1 million for the third quarter of 2006. The increase was due to an increase in average earning assets of \$635.9 million as compared to the third quarter of 2006. The increase in average earning assets included a \$716.4 million increase in average loans held for investment offset by a slight decrease in average loans held for sale and a \$75.0 million decrease in average securities. For the quarter ended September 30, 2007, average net loans and securities represented 87% and 13%, respectively, of average earning assets compared to 82% and 18% in the same quarter of 2006.

Average interest bearing liabilities increased \$555.9 million from the third quarter of 2006, which included a \$385.1 million increase in interest bearing deposits and a \$130.5 million increase in other borrowings. The average cost of interest bearing liabilities remained constant at 4.87% for the quarter ended September 30, 2007 from the same period of 2006.

Net interest income was \$102.9 million for the first nine months of 2007, compared to \$86.0 million for the same period of 2006. The increase was due to an increase in average earning assets of \$607.0 million as compared to 2006 offset by a 2 basis point decrease in net interest margin. The increase in average earning assets included a \$640.6 million increase in average loans held for investment and an increase of \$57.5 million in loans held for sale, offset by an \$87.1 million decrease in average securities. For the nine months ended September 30, 2007, average net loans and securities represented 86% and 14%, respectively, of average earning assets compared to 80% and 19% in the same period of 2006.

Average interest bearing liabilities increased \$563.5 million compared to the first nine months of 2006, which included a \$493.1 million increase in interest bearing deposits and an \$18.4 million increase in other borrowings. The average cost of interest bearing liabilities increased from 4.51% for the nine months ended September 30, 2006 to 4.90% for the same period of 2007, reflecting the rising market interest rates and change in funding mix.

**Table of Contents****TABLE 1 VOLUME/RATE ANALYSIS**

(In thousands)

|                                 | Three months ended<br>September 30, 2007/2006 |                              |            | Nine months ended<br>September 30, 2007/2006 |                              |            |
|---------------------------------|---|------------------------------|------------|--|------------------------------|------------|
|                                 | 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>       | \$ (863)                                      | \$ (896)                     | \$ 33      | \$ (2,584)                                   | \$ (3,040)                   | \$ 456     |
| Loans held for sale             | (129)   | (4)                          | (125)      | 3,196  | 2,992                        | 204        |
| Loans held for<br>investment    | 14,528  | 15,482                       | (954)      | 44,411                                       | 39,790                       | 4,621      |
| Federal funds sold              | (12)  | (12)                         |            | (24)   | (26)                         | 2          |
| Deposits in other banks         | (2)   | (3)                          | 1          | 4  | 1                            | 3          |
| Total                           | 13,522  | 14,567                       | (1,045)    | 45,003                                       | 39,717                       | 5,286      |
| Interest expense:               |   |                              |            |  |                              |            |
| Transaction deposits            | (45)  | (10)                         | (35)       | (149)  | (94)                         | (55)       |
| Savings deposits                | 690   | 899                          | (209)      | 5,205  | 3,338                        | 1,867      |
| Time deposits                   | 1,808   | 1,464                        | 344        | 5,532  | 2,542                        | 2,990      |
| Deposits in foreign<br>branches | 1,900   | 2,569                        | (669)      | 12,710                                       | 12,131                       | 579        |
| Borrowed funds                  | 2,509   | 2,419                        | 90         | 4,789  | 3,484                        | 1,305      |
| Total                           | 6,862   | 7,341                        | (479)      | 28,087                                       | 21,401                       | 6,686      |
| Net interest income             | \$ 6,660                                      | \$ 7,226                     | \$ (566)   | \$16,916                                     | \$18,316                     | \$(1,400)  |

(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 3.86% for the third quarter of 2007 compared to 3.80% for the third quarter of 2006. The increase in net interest margin resulted primarily from a 9 basis point increase in the yield on earning assets while interest expense as a percentage of earning assets increased by only 3 basis points.



**Non-interest Income****TABLE 2 NON-INTEREST INCOME**

(In thousands)

|   | Three months ended |                | Nine months ended |                 |
|---|--------------------|----------------|-------------------|-----------------|
|   | September 30       |                | September 30      |                 |
|   | 2007               | 2006           | 2007              | 2006            |
| Service charges on deposit accounts     | \$1,089            | \$ 780         | \$ 2,935          | \$ 2,441        |
| Trust fee income                        | 1,182              | 1,008          | 3,453             | 2,717           |
| Bank owned life insurance (BOLI) income | 288                | 255            | 887               | 833             |
| Brokered loan fees                      | 452                | 656            | 1,505             | 1,508           |
| Equipment rental income                 | 1,581              | 1,147          | 4,533             | 2,475           |
| Other                                   | 55                 | 632            | 1,758             | 2,234           |
| <b>Total non-interest income</b>        | <b>\$4,647</b>     | <b>\$4,478</b> | <b>\$15,071</b>   | <b>\$12,208</b> |

Non-interest income increased \$169,000 compared to the same quarter of 2006. The increase is primarily related to a \$434,000 increase in equipment rental income from \$1.1 million to \$1.6 million related to expansion of our operating lease portfolio. Additionally, service charge income increased \$309,000 primarily due to new pricing and trust fee income increased \$174,000 due to continued growth of trust assets. Offsetting these increases was reduced contribution from the mortgage warehouse division, including brokered loan fees and mark to market of the certain loans. Due to uncertain market conditions, future results from the mortgage warehouse division could be subject to wider fluctuations.

Non-interest income increased \$2.9 million during the nine months ended September 30, 2007 to \$15.1 million compared to \$12.2 million during the same period of 2006. The increase is primarily related to a \$2.0 million increase in equipment rental income from \$2.5 million to \$4.5 million related to expansion of our operating lease portfolio. Additionally, service charge income increased \$494,000 primarily due to new pricing and trust fee income increased \$736,000 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****TABLE 3 NON-INTEREST EXPENSE**

(In thousands)

|                                    | Three months ended |           | Nine months ended |           |
|------------------------------------|--------------------|-----------|-------------------|-----------|
|                                    | September 30       |           | September 30      |           |
|                                    | 2007               | 2006      | 2007              | 2006      |
| Salaries and employee benefits     | \$ 15,254          | \$ 12,542 | \$ 44,573         | \$ 36,871 |
| Net occupancy expense              | 2,194              | 1,907     | 6,269             | 5,872     |
| Leased equipment depreciation      | 1,311              | 928       | 3,722             | 2,095     |
| Marketing                          | 669                | 690       | 2,154             | 2,298     |
| Legal and professional             | 1,799              | 1,590     | 5,202             | 4,402     |
| Communications and data processing | 849                | 843       | 2,519             | 2,268     |
| Franchise taxes                    | 46                 | 58        | 176               | 223       |
| Other                              | 3,772              | 3,077     | 10,785            | 8,890     |
| Total non-interest expense         | \$ 25,894          | \$ 21,635 | \$ 75,400         | \$ 62,919 |

Non-interest expense for the third quarter of 2007 increased \$4.3 million, or 20%, to \$25.9 million from \$21.6 million, and is primarily attributable to a \$2.8 million increase in salaries and employee benefits to \$15.3 million from \$12.5 million. The increase in salaries and employee benefits resulted from growth, including higher level of variable incentives.

Net occupancy expense for the three months ended September 30, 2007 increased \$287,000, or 15%, compared to the same quarter in 2006 relating to our general business growth. Leased equipment depreciation for the three months ended September 30, 2007 increased by \$383,000 to \$1.3 million from \$928,000 compared to the same quarter in 2006 relating to expansion of our operating lease portfolio.

Marketing expense decreased \$21,000, or 3%. Marketing expense for the three months ended September 30, 2007 included \$100,000 of direct marketing and promotions and \$347,000 for business development compared to direct marketing and promotions of \$56,000 and business development of \$368,000 during the same period for 2006.

Marketing expense for the three months ended September 30, 2007 also included \$222,000 for the purchase of miles related to the American Airlines AAdvantage<sup>®</sup> program compared to \$266,000 for the same period for 2006. 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, 2007 increased \$209,000, or 13% compared to the same quarter in 2006 mainly related to growth. Regulatory and compliance costs continue to be a factor in our expense growth and we anticipate that they will continue to increase. Audit, legal and consulting costs related to compliance are included in legal and professional and the new FDIC assessment is included in other expense.

Non-interest expense for the first nine months of 2007 increased \$12.5 million, or 20%, to \$75.4 million from \$62.9 million during the same period in 2006. This increase is primarily related to a \$7.7 million increase in salaries and employee benefits to \$44.6 million from \$36.9 million. The increase in salaries and employee benefits resulted from growth, including higher level of variable incentives.

Net occupancy expense for the nine months ended September 30, 2007 increased \$397,000, or 7%, compared to the same period in 2006 relating to our general business growth. Leased equipment depreciation for the nine months

ended September 30, 2007 increased \$1.6 million to \$3.7 million from \$2.1 million compared to the same period in 2006 relating to expansion of our operating lease portfolio.

Marketing expense decreased \$144,000, or 6%, compared to the first nine months of 2006. Marketing expense

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for the nine months ended September 30, 2007 included \$317,000 of direct marketing and promotions and \$1.2 million for business development compared to direct marketing and promotions of \$154,000 and business development of \$1.3 million during the same period for 2006. Marketing expense for the nine months ended September 30, 2007 also included \$655,000 for the purchase of miles related to the American Airlines AAdvantage® program, compared to \$844,000 for the same period for 2006. 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.

Legal and professional expense for the nine months ended September 30, 2007 increased \$800,000, or 18%, compared to the same period in 2006 mainly related to growth and increased cost of compliance with laws and regulations.

Regulatory and compliance costs continue to be a factor in our expense growth and we anticipate that they will continue to increase. Audit, legal and consulting costs related to compliance are included in legal and professional and the new FDIC assessment is included in other expense. Communications and data processing expense for the six months ended September 30, 2007 increased \$251,000, or 11%, compared to the same period in 2006 primarily as a result of growth.

**Analysis of Financial Condition**

The aggregate loan portfolio at September 30, 2007 increased \$480.7 million from December 31, 2006 to \$3.4 billion. Commercial loans, construction, real estate and consumer loans increased \$340.3 million, \$45.3 million, \$178.2 million and \$1.8 million, respectively. Leases also increased \$11.9 million. Loans held for sale decreased \$80.8 million.

**TABLE 4 LOANS**

(In thousands)

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| Commercial  | \$1,942,867           | \$1,602,577          |
| Construction                                      | 583,843               | 538,586              |
| Real estate                                       | 708,560               | 530,377              |
| Consumer  | 22,942                | 21,113               |
| Leases  | 57,155                | 45,280               |
| Gross loans held for investment                   | 3,315,367             | 2,737,933            |
| Deferred income (net of direct origination costs) | (19,328)              | (15,836)             |
| Allowance for loan losses                         | (26,003)              | (21,003)             |
| Total loans held for investment, net              | 3,270,036             | 2,701,094            |
| Loans held for sale                               | 118,221               | 199,014              |
| Loans held for sale from discontinued operations  | 863                   | 16,844               |
| Total loans, net                                  | \$3,389,120           | \$2,916,952          |

We continue to lend primarily in Texas. As of September 30, 2007, 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 2007, the Company recorded net charge-offs in the amount of \$59,000, compared to net recoveries of \$445,000 for the same period in 2006. The reserve for loan losses, which is available to absorb losses

inherent in the loan portfolio, totaled \$26.0 million at September 30, 2007, \$21.0 million at December 31, 2006 and \$20.8 million at September 30, 2006. This represents 0.79%, 0.77% and 0.82% of loans held for investment (net of unearned income) at September 30, 2007, December 31, 2006 and September 30, 2006, 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. Due primarily to loan growth, we recorded a \$2.0 million provision for loan losses during the third quarter of

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2007 compared to \$750,000 in the third quarter of 2006 and \$1.5 million in the second quarter of 2007.

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 and 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 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, 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.

The reserve allocation percentages assigned to each credit grade have been developed based 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, changes in composition of the portfolio by risk grade, lending standards and changes in the trend and severity of problem loans, can cause the estimation of future losses to differ from past experience. The unallocated portion of the general reserve serves to compensate for additional areas of uncertainty and considers industry trends. 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 allowance, which has declined as a percent of total loans, is considered adequate and appropriate based upon management's assessment of the credit quality of the loan portfolio and the consistent application of the approved reserve methodology, which incorporates 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 responsive to changes in portfolio credit quality and credit losses inherent in the portfolio. The changes are reflected in the general reserve and in specific reserves as the collectibility 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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(In thousands)

|   | Nine months<br>ended<br>September<br>30,<br>2007 | Nine months<br>ended<br>September 30,<br>2006 | Year ended<br>December<br>31,<br>2006 |
|---|--|---|---------------------------------------|
| Beginning balance   | \$21,003   | \$ 18,897                                     | \$18,897                              |
| Loans charged-off:  |  |   |                                       |
| Commercial  | 339  | 1,688   | 2,525                                 |
| Consumer  | 48   | 3   | 3                                     |
| Leases  | 68   | 40  | 76                                    |
| Total charge-offs   | 455  | 1,731   | 2,604                                 |
| Recoveries:   |  |   |                                       |
| Commercial  | 625  | 450   | 462                                   |
| Consumer  | 14   | 1   | 1                                     |
| Leases  | 116  | 224   | 247                                   |
| Total recoveries  | 755  | 675   | 710                                   |
| Net charge-offs (recoveries)                                    | (300)  | 1,056   | 1,894                                 |
| Provision for loan losses                                       | 4,700  | 3,000   | 4,000                                 |
| Ending balance  | \$26,003   | \$ 20,841                                     | \$21,003                              |
| Reserve to loans held for investment <sup>(2)</sup>             | .79%   | .82%  | .77%                                  |
| Net charge-offs (recoveries) to average loans <sup>(1)(2)</sup> | (.01)%   | .06%  | .08%                                  |
| Provision for loan losses to average loans <sup>(1)(2)</sup>    | .21%   | .17%  | .17%                                  |
| Recoveries to total charge-offs                                 | 165.93%  | 38.99%  | 27.27%                                |
| Non-performing and renegotiated loans:                          |  |   |                                       |
| Non-accrual   | \$ 8,690   | \$ 6,432                                      | \$ 9,088                              |
| Loans past due 90 days and accruing <sup>(3) (4)</sup>          | 4,356  | 2,627   | 2,142                                 |
| Total <sup>(4)</sup>  | \$13,046   | \$ 9,059                                      | \$11,230                              |
| Other real estate owned   | \$ 501   | \$ 882  | \$ 882                                |
| Reserve as a percent of non-performing loans <sup>(2)</sup>     | 2.0x   | 2.3x  | 1.9x                                  |

(1) Interim period ratios are annualized.

- (2) Excludes loans held for sale.
- (3) At September 30, 2007, \$1.3 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. The total also includes \$274,000 USDA guaranteed loans.
- (4) At September 30, 2007, non-performing assets include \$2.4 million of mortgage warehouse loans that were transferred from loans held for sale to loans held for



investment at  
lower of cost or  
market.

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

|                         | September<br>30,<br>2007 | December<br>31,<br>2006 | September<br>30,<br>2006 |
|-------------------------|--------------------------|-------------------------|--------------------------|
| Non-accrual loans:      |                          |                         |                          |
| Commercial              | \$ 2,601                 | \$ 5,587                | \$ 2,879                 |
| Construction            | 4,952                    |                         |                          |
| Real estate             | 1,118                    | 3,417                   | 3,460                    |
| Consumer                | 12                       | 63                      | 63                       |
| Leases                  | 7                        | 21                      | 30                       |
| Total non-accrual loans | \$ 8,690                 | \$ 9,088                | \$ 6,432                 |

At September 30, 2007, we had \$4.4 million in loans past due 90 days and still accruing interest. At September 30, 2007, \$1.3 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. The total also includes \$274,000 USDA guaranteed loans. At September 30, 2007, we had \$590,000 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 collectibility is questionable, then cash payments are applied to principal. As of September 30, 2007, approximately \$1.8 million 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.

**Securities Portfolio**

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

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

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

Our unrealized loss on the securities portfolio value increased from a loss of \$8.0 million, which represented 1.49% of the amortized cost at December 31, 2006, to a loss of \$7.0 million, which represented 1.45% of the amortized cost at September 30, 2007.

The following table discloses, as of September 30, 2007, 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):



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|                            | Less Than 12 Months |                 | 12 Months or Longer |                 | Total      |                 |
|----------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
|                            | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasuries            | \$ 2,593            | \$              | \$                  | \$              | \$ 2,593   | \$              |
| Mortgage-backed securities |                     |                 | 297,795             | (6,788)         | 297,795    | (6,788)         |
| Corporate securities       | 4,995               | (6)             | 30,233              | (258)           | 35,228     | (264)           |
| Municipals                 | 14,153              | (75)            | 25,588              | (344)           | 39,741     | (419)           |
| Equity securities          |                     |                 | 3,506               | (139)           | 3,506      | (139)           |
|                            | \$ 21,741           | \$ (81)         | \$ 357,122          | \$ (7,529)      | \$ 378,863 | \$ (7,610)      |

The number of investment positions in this unrealized loss position totals 140. 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 due to rising rates in 2006 in relation to previous rates in 2004 and 2005. We have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities.

**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, 2006 and for the nine months ended September 30, 2007, 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 primarily been fulfilled through growth in our core customer deposits. Our goal is to obtain as much of our funding as possible from deposits of these core customers, which as of September 30, 2007, comprised \$3,290.6 million, or 99.8%, of total 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. As of September 30, 2007, brokered retail CDs comprised \$5.1 million, or 0.2%, of total deposits. We have access to sources of brokered deposits of not less than \$995 million.

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, 2007, our borrowings consisted of a total of \$7.8 million of customer repurchase agreements and \$216.7 million of downstream federal funds purchased. 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, 2007, we had \$125.0 million in borrowings from the FHLB. FHLB borrowings are collateralized by eligible securities and loans. Our unused FHLB borrowing capacity at September 30, 2007 was approximately \$486.1 million. As of September 30, 2007, we had unused upstream federal fund lines available from commercial banks of approximately \$431.6 million. During the nine months ended September 30, 2007, our average other borrowings from these sources were \$349.3 million, of which \$29.0 million related to customer repurchase

agreements. The maximum amount of borrowed funds outstanding at any month-end during the first nine months of 2007 was \$652.3 million, of which \$22.6 related to customer repurchase agreements.

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Our equity capital averaged \$265.7 million for the nine months ended September 30, 2007 as compared to \$224.8 million for the same period in 2006. 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.

As of September 30, 2007, our significant fixed and determinable contractual obligations to third parties were as follows (in thousands):

|  | Within One<br>Year | After One<br>but<br>Within<br>Three Years | After<br>Three but<br>Within<br>Five Years | After Five<br>Years | Total        |
|--|--------------------|---|--|---------------------|--------------|
| Deposits without a stated maturity <sup>(1)</sup>      | \$ 1,499,502       | \$  | \$   | \$                  | \$ 1,499,502 |
| Time deposits <sup>(1)</sup>                           | 1,677,242          | 100,069                                   | 18,831                                     | 63                  | 1,796,205    |
| Federal funds purchased <sup>(1)</sup>                 | 216,744            |   |  |                     | 216,744      |
| Customer repurchase agreements <sup>(1)</sup>          | 7,820              |   |  |                     | 7,820        |
| Treasury, tax and loan notes <sup>(1)</sup>            | 3,946              |   |  |                     | 3,946        |
| FHLB borrowing <sup>(1)</sup>                          | 125,000            |   |  |                     | 125,000      |
| Short-term borrowing <sup>(1)</sup>                    | 5,000              |   |  |                     | 5,000        |
| Operating lease obligations                            | 6,390              | 13,486                                    | 8,670                                      | 34,465              | 63,011       |
| Trust preferred subordinated debentures <sup>(1)</sup> |                    |   |  | 113,406             | 113,406      |
| Total contractual obligations                          | \$ 3,541,644       | \$ 113,555                                | \$ 27,501                                  | \$ 147,934          | \$ 3,830,634 |

(1) Excludes interest

**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 in the 2006 Form 10-K. 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 Statement of Financial Accounting Standards (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**

The Company's interest rate sensitivity is illustrated in the following table. The table reflects rate-sensitive positions as of September 30, 2007, 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, 2007**

(In thousands)

|  | 0-3 mo<br>Balance | 4-12 mo<br>Balance | 1-3 yr<br>Balance | 3+ yr<br>Balance | Total<br>Balance |
|--|-------------------|--------------------|-------------------|------------------|------------------|
| Securities <sup>(1)</sup>                  | \$ 32,407         | \$ 74,152          | \$ 140,221        | \$ 229,668       | \$ 476,448       |
| Total variable loans                       | 2,809,197         | 19,434             | 1,403             | 10,044           | 2,840,078        |
| Total fixed loans                          | 167,112           | 134,021            | 176,127           | 117,113          | 594,373          |
| Total loans <sup>(2)</sup>                 | 2,976,309         | 153,455            | 177,530           | 127,157          | 3,434,451        |
| Total interest sensitive assets            | \$ 3,008,716      | \$ 227,607         | \$ 317,751        | \$ 356,825       | \$ 3,910,899     |
| Liabilities:                               |                   |                    |                   |                  |                  |
| Interest bearing customer deposits         | \$ 2,064,182      | \$                 | \$                | \$               | \$ 2,064,182     |
| CD s & IRA s                               | 259,531           | 377,027            | 99,899            | 18,894           | 755,351          |
| Wholesale deposits                         |                   | 4,896              | 169               |                  | 5,065            |
| Total interest bearing deposits            | 2,323,713         | 381,923            | 100,068           | 18,894           | 2,824,598        |
| Repo, FF, FHLB borrowings                  | 353,510           | 5,000              |                   |                  | 358,510          |
| Trust preferred subordinated<br>debentures |                   |                    |                   | 113,406          | 113,406          |
| Total borrowings                           | 353,510           | 5,000              |                   | 113,406          | 471,916          |
| Total interest sensitive liabilities       | \$ 2,677,223      | \$ 386,923         | \$ 100,068        | \$ 132,300       | \$ 3,296,514     |
| GAP  | 331,493           | (159,316)          | 217,683           | 224,525          |                  |
| Cumulative GAP                             | 331,493           | 172,177            | 389,860           | 614,385          | 614,385          |
| Demand deposits                            |                   |                    |                   |                  | \$ 471,109       |
| Stockholders equity                        |                   |                    |                   |                  | 284,209          |
| Total                                      |                   |                    |                   |                  | \$ 755,318       |

(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, 2007 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 London Interbank Offering Rate 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.

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

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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:

**TABLE 7 INTEREST RATE SENSITIVITY**

(In thousands)

|                               | Anticipated Impact Over the Next Twelve Months |                    |
|-------------------------------|--|--------------------|
|                               | as Compared to Most Likely Scenario            |                    |
|                               | 200 bp Increase                                | 200 bp Decrease    |
|                               | September 30, 2007                             | September 30, 2007 |
| Change in net interest income | \$ 9,805                                       | \$ (10,328)        |

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, 2007, 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 2006 Form 10-K for the fiscal year ended December 31, 2006.

**ITEM 6. EXHIBITS**

(a) Exhibits

- 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 31, 2007

/s/ Peter B. Bartholow  
Peter B. Bartholow  
Chief Financial Officer (Duly authorized  
officer and principal financial officer)  
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**EXHIBIT INDEX**

Exhibit Number

- 3.6 First Amendment to the Amended and Restated Bylaws of Texas Capital Bancshares, Inc., dated as of July 17, 2007, which is incorporated by reference to our Current Report on Form 8-K dated July 17, 2007.
- 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.
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