

TEXAS CAPITAL BANCSHARES INC/TX

Form 10-Q

May 03, 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 and Exchange Act of 1934.  
For the quarterly period ended March 31, 2007**

**Transition Report pursuant to Section 13 or 15(d) of the Securities and 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 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 April 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 26,117,765

Texas Capital Bancshares, Inc.  
Form 10-Q  
Quarter Ended March 31, 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 share data)

|  | Three months ended March 31 |               |
|--|-----------------------------|---------------|
|  | 2007                        | 2006          |
| <b>Interest income</b>                                     |                             |               |
| Interest and fees on loans                                 | \$61,174                    | \$43,800      |
| Securities   | 5,969                       | 6,831         |
| Federal funds sold   | 5                           | 24            |
| Deposits in other banks                                    | 15                          | 11            |
| <b>Total interest income</b>                               | <b>67,163</b>               | <b>50,666</b> |
| <b>Interest expense</b>                                    |                             |               |
| Deposits   | 30,890                      | 19,307        |
| Federal funds purchased                                    | 2,153                       | 1,908         |
| Repurchase agreements                                      | 394                         | 1,202         |
| Other borrowings   | 12                          | 554           |
| Debt   | 2,047                       | 828           |
| <b>Total interest expense</b>                              | <b>35,496</b>               | <b>23,799</b> |
| <b>Net interest income</b>                                 | <b>31,667</b>               | <b>26,867</b> |
| <b>Provision for loan losses</b>                           | <b>1,200</b>                |               |
| <b>Net interest income after provision for loan losses</b> | <b>30,467</b>               | <b>26,867</b> |
| <b>Non-interest income</b>                                 |                             |               |
| Service charges on deposit accounts                        | 893                         | 856           |
| Trust fee income   | 1,077                       | 843           |
| Bank owned life insurance (BOLI) income                    | 298                         | 286           |
| Brokered loan fees   | 479                         | 369           |
| Equipment rental income                                    | 1,459                       | 513           |
| Other  | 930                         | 875           |
| <b>Total non-interest income</b>                           | <b>5,136</b>                | <b>3,742</b>  |
| <b>Non-interest expense</b>                                |                             |               |
| Salaries and employee benefits                             | 14,557                      | 11,846        |
| Net occupancy expense                                      | 2,020                       | 2,011         |
| Leased equipment depreciation                              | 1,207                       | 381           |
| Marketing  | 757                         | 702           |
| Legal and professional                                     | 1,661                       | 1,452         |
| Communications and data processing                         | 832                         | 692           |
| Franchise taxes  | 41                          | 61            |
| Other  | 3,020                       | 2,984         |
| <b>Total non-interest expense</b>                          | <b>24,095</b>               | <b>20,129</b> |

|   |          |          |
|---|----------|----------|
| <b>Income from continuing operations before income taxes</b>  | 11,508   | 10,480   |
| Income tax expense  | 3,922    | 3,573    |
| <b>Income from continuing operations</b>                      | 7,586    | 6,907    |
| <b>Income (loss) from discontinued operations (after-tax)</b> | 36       | (264)    |
| <b>Net income</b>   | \$ 7,622 | \$ 6,643 |
| <br>  |          |          |
| <b>Basic earnings per share:</b>                              |          |          |
| Income from continuing operations                             | \$ .29   | \$ .27   |
| Net income  | \$ .29   | \$ .26   |
| <br>  |          |          |
| <b>Diluted earnings per share:</b>                            |          |          |
| Income from continuing operations                             | \$ .29   | \$ .26   |
| Net income  | \$ .29   | \$ .25   |
| See accompanying notes to consolidated financial statements.  |          |          |

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

(In thousands except share data)

|  | March 31,<br>2007 | December 31,<br>2006 |
|--|-------------------|----------------------|
|  | (Unaudited)       |                      |
| <b>Assets</b>  |                   |                      |
| Cash and due from banks  | \$ 106,653        | \$ 93,716            |
| Federal funds sold   | 20                |                      |
| Securities, available-for-sale   | 508,296           | 532,053              |
| Loans held for sale  | 208,074           | 199,014              |
| Loans held for sale from discontinued operations   | 12,525            | 16,844               |
| Loans held for investment (net of unearned income)   | 2,885,963         | 2,722,097            |
| Less: Allowance for loan losses  | 22,589            | 21,003               |
| Loans held for investment, net   | 2,863,374         | 2,701,094            |
| Premises and equipment, net  | 34,350            | 33,818               |
| Accrued interest receivable and other assets   | 78,492            | 85,821               |
| Goodwill and intangible assets, net  | 7,973             | 12,989               |
| Total assets   | \$3,819,757       | \$3,675,349          |
| <b>Liabilities and Stockholders Equity</b>   |                   |                      |
| Liabilities:   |                   |                      |
| Deposits:  |                   |                      |
| Non-interest bearing   | \$ 507,686        | \$ 513,930           |
| Interest bearing   | 1,621,299         | 1,670,956            |
| Interest bearing in foreign branches   | 957,752           | 884,444              |
| Total deposits   | 3,086,737         | 3,069,330            |
| Accrued interest payable   | 7,895             | 5,781                |
| Other liabilities  | 16,985            | 21,758               |
| Federal funds purchased  | 288,640           | 165,955              |
| Repurchase agreements  | 42,478            | 43,359               |
| Other borrowings   |                   | 2,245                |
| Debt   | 113,406           | 113,406              |
| Total liabilities  | 3,556,141         | 3,421,834            |
| Stockholders equity:   |                   |                      |
| Common stock, \$.01 par value:   |                   |                      |
| Authorized shares 100,000,000  |                   |                      |
| Issued shares 26,101,994 and 26,065,124 at March 31, 2007 and<br>December 31, 2006, respectively | 261               | 261                  |
| Additional paid-in capital   | 184,038           | 182,321              |
| Retained earnings  | 83,785            | 76,163               |

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|  |             |             |
|--|-------------|-------------|
| Treasury stock (shares at cost: 84,691 and 84,274 at March 31, 2007 and December 31, 2006) | (581)       | (573)       |
| Deferred compensation  | 573         | 573         |
| Accumulated other comprehensive loss, net of taxes   | (4,460)     | (5,230)     |
| Total stockholders' equity   | 263,616     | 253,515     |
| Total liabilities and stockholders' equity   | \$3,819,757 | \$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<br>Shares | Stock<br>Amount | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Treasury<br>Shares | Stock<br>Amount | Deferred<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>(Loss) | Total      |
|--|------------------|-----------------|----------------------------------|----------------------|--------------------|-----------------|--------------------------|---|------------|
| Balance at<br>December 31, 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 unrealized<br>gain (loss) on<br>available-for-sale<br>securities, net of taxes<br>of \$1,547           |                  |                 |                                  |                      |                    |                 |                          | 2,875   | 2,875      |
| Total comprehensive<br>income  |                  |                 |                                  |                      |                    |                 |                          |   | 31,799     |
| Tax benefit related to<br>exercise of stock<br>options   |                  |                 | 1,431                            |                      |                    |                 |                          |   | 1,431      |
| Stock-based<br>compensation<br>expense recognized in<br>earnings   |                  |                 | 2,847                            |                      |                    |                 |                          |   | 2,847      |
| Issuance of common<br>stock  | 293,406          | 3               | 1,912                            |                      |                    |                 |                          |   | 1,915      |
| Balance at<br>December 31, 2006  | 26,065,124       | 261             | 182,321                          | 76,163               | (84,274)           | (573)           | 573                      | (5,230)   | 253,515    |
| Comprehensive<br>income:   |                  |                 |                                  |                      |                    |                 |                          |   |            |
| Net income<br>(unaudited)  |                  |                 |                                  | 7,622                |                    |                 |                          |   | 7,622      |
| Change in unrealized<br>gain (loss) on<br>available-for-sale<br>securities, net of taxes<br>of \$415 (unaudited) |                  |                 |                                  |                      |                    |                 |                          | 770   | 770        |
| Total comprehensive<br>income (unaudited)  |                  |                 |                                  |                      |                    |                 |                          |   | 8,392      |
| Tax benefit related to<br>exercise of stock<br>options (unaudited)   |                  |                 | 125                              |                      |                    |                 |                          |   | 125        |



|   |            |        |            |           |          |          |        |            |            |
|---|------------|--------|------------|-----------|----------|----------|--------|------------|------------|
| Stock-based compensation expense recognized in earnings (unaudited) |            |        | 1,252      |           |          |          |        |            | 1,252      |
| Issuance of stock related to stock-based awards (unaudited)         | 36,870     |        | 340        |           |          |          |        |            | 340        |
| Purchase of treasury stock (unaudited)                              |            |        |            |           | (417)    | (8)      |        |            | (8)        |
| Balance at March 31, 2007 (unaudited)                               | 26,101,994 | \$ 261 | \$ 184,038 | \$ 83,785 | (84,691) | \$ (581) | \$ 573 | \$ (4,460) | \$ 263,616 |

See accompanying notes to consolidated financial statements.

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

(In thousands)

|   | Three months ended March 31 |           |
|---|-----------------------------|-----------|
|   | 2007                        | 2006      |
| <b>Operating activities</b>   |                             |           |
| Net income  | \$ 7,622                    | \$ 6,643  |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                             |           |
| Provision for loan losses   | 1,200                       |           |
| Depreciation and amortization   | 1,773                       | 896       |
| Amortization and accretion on securities  | 77                          | 413       |
| Bank owned life insurance (BOLI) income   | (298)                       | (286)     |
| Stock-based compensation expense  | 1,252                       | 644       |
| Tax benefit from stock option exercises   | 125                         | 363       |
| Excess tax benefits from stock-based compensation arrangements                              | (358)                       | (1,038)   |
| Originations of loans held for sale   | (994,646)                   | (496,945) |
| Proceeds from sales of loans held for sale  | 985,586                     | 473,881   |
| Changes in operating assets and liabilities:  |                             |           |
| Accrued interest receivable and other assets  | 7,627                       | 230       |
| Accrued interest payable and other liabilities  | (3,074)                     | (298)     |
| Net cash (used in) provided by operating activities of continuing operations                | 6,886                       | (15,497)  |
| Net cash (used in) provided by operating activities of discontinued operations              | 8,669                       | (2,654)   |
| Net cash (used in) provided by operating activities   | 15,555                      | (18,151)  |
| <b>Investing activities</b>   |                             |           |
| Purchases of available-for-sale securities  | (2,867)                     | (5,048)   |
| Maturities and calls of available-for-sale securities                                       | 7,127                       | 2,600     |
| Principal payments received on securities   | 20,605                      | 25,554    |
| Net increase in loans   | (162,284)                   | (180,085) |
| Purchase of premises and equipment, net   | (2,835)                     | (650)     |
| Net cash used in investing activities of continuing operations                              | (140,254)                   | (157,629) |
| Net cash used in investing activities of discontinued operations                            |                             |           |
| Net cash used in investing activities   | (140,254)                   | (157,629) |
| <b>Financing activities</b>   |                             |           |
| Net decrease in checking, money market and savings accounts                                 | (134,973)                   | (44,347)  |
| Net increase in certificates of deposit   | 152,380                     | 12,887    |
| Issuance of stock related to stock-based awards   | 340                         | 521       |
| Net other borrowings  | (3,126)                     | 16,580    |
| Excess tax benefits from stock-based compensation arrangements                              | 358                         | 1,038     |
| Net federal funds purchased   | 122,685                     | 159,690   |
| Sale of treasury stock  | (8)                         |           |

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|  |            |            |
|--|------------|------------|
| Net cash provided by financing activities of continuing operations   | 137,656    | 146,369    |
| Net cash provided by financing activities of discontinued operations |            |            |
| Net cash provided by financing activities                            | 137,656    | 146,369    |
| Net increase (decrease) in cash and cash equivalents                 | 12,957     | (29,411)   |
| Cash and cash equivalents at beginning of period                     | 93,716     | 137,840    |
| Cash and cash equivalents at end of period                           | \$ 106,673 | \$ 108,429 |
| Supplemental disclosures of cash flow information:                   |            |            |
| Cash paid during the period for interest                             | \$ 33,382  | \$ 24,007  |
| Cash paid during the period for income taxes                         | 11         | 221        |
| Non-cash transactions:   |            |            |
| Transfers from loans/leases to premises and equipment                | 556        | 209        |
| See accompanying notes to consolidated financial statements.         |            |            |

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**TEXAS CAPITAL BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED**

**(1) ACCOUNTING POLICIES**

**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, Texas Capital Bank, National Association (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).

**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, 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 months ended March 31, 2007, we recognized stock-based compensation expense of \$1,251,000 or \$825,000 net of tax. Stock-based compensation expense related to stock options represents \$0.03 in diluted earnings per share during the three months ended March 31, 2007. The amount for the three months ended March 31, 2007 is comprised of \$370,000 related to unvested options issued prior to the adoption of SFAS 123R, \$395,000 related to SARs issued during 2006 and 2007, and \$486,000 related to RSUs issued in 2006 and 2007. Cash flows from financing activities for the three months ended March 31, 2007 included \$358,000 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 \$3.0 million, pre-tax. At March 31, 2007, the weighted average period over which this unrecognized expense is expected to be recognized was 1.8 years. Unrecognized stock-based compensation expense related to grants during 2006 and 2007 is \$13.4 million. At March 31, 2007, the weighted average period over which this unrecognized expense is expected to be recognized was 2.8 years.

**Table of Contents****(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 March 31 |            |
|--|-----------------------------|------------|
|  | 2007                        | 2006       |
| Numerator:   |                             |            |
| Net income from continuing operations  | \$ 7,586                    | \$ 6,907   |
| Income (loss) from discontinued operations   | 36                          | (264)      |
| Net income   | \$ 7,622                    | \$ 6,643   |
| Denominator:   |                             |            |
| Denominator for basic earnings per share-weighted average shares                                     | 26,087,077                  | 25,825,352 |
| Effect of employee stock options: <sup>(1)</sup>   | 353,478                     | 742,541    |
| Denominator for dilutive earnings per share-adjusted weighted average shares and assumed conversions | 26,440,555                  | 26,567,893 |
| Basic earnings per share from continuing operations  | \$ .29                      | \$ .27     |
| Basic earnings per share from discontinued operations  |                             | (.01)      |
| Basic earnings per share   | \$ .29                      | \$ .26     |
| Diluted earnings per share from continuing operations  | \$ .29                      | \$ .26     |
| Diluted earnings per share from discontinued operations  |                             | (.01)      |
| Diluted earnings per share   | \$ .29                      | \$ .25     |

(1) Stock options outstanding of 952,170 at March 31, 2007 and 62,500 at March 31, 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.

**(3) 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.

|   |                   |
|---|-------------------|
| (In thousands)  | March 31,<br>2007 |
| Financial instruments whose contract amounts represent credit risk: |                   |
| Commitments to extend credit  | \$1,115,546       |
| Standby letters of credit   | 60,204            |

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**(4) DISCONTINUED OPERATIONS**

On March 30, 2007, Texas Capital Bank completed the sale of its TexCap Insurance Services 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.

Subsequent to the end of the quarter, Texas Capital Bank and the purchaser of its 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. The Company will complete the exiting of RML's activities. Results of discontinued operations include an after-tax charge of \$1.06 million for the first quarter of 2007, representing estimated and actual costs associated with the exiting of RML's remaining activities.

**(5) NEW ACCOUNTING PRONOUNCEMENTS**

On January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in 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. We are no longer subject to U.S. Federal income tax examinations by tax authorities for years before 2003.

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

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

|   | For the three months ended<br>March 31, 2007 |                                    |                | For the three months ended<br>March 31, 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                                | \$ 467,219                                   | \$ 5,535                           | 4.80%          | \$ 567,653                                   | \$ 6,396                           | 4.57%          |
| Securities non-taxable <sup>(2)</sup>             | 48,549                                       | 668                                | 5.58%          | 48,635                                       | 669                                | 5.58%          |
| Federal funds sold                                | 418  | 5                                  | 4.85%          | 2,233  | 24                                 | 4.36%          |
| Deposits in other banks                           | 1,097  | 15                                 | 5.55%          | 1,079  | 11                                 | 4.13%          |
| Loans held for sale from continuing<br>operations | 156,400                                      | 2,791                              | 7.24%          | 71,282                                       | 1,154                              | 6.57%          |
| Loans   | 2,767,834                                    | 58,383                             | 8.55%          | 2,168,410                                    | 42,646                             | 7.98%          |
| Less reserve for loan losses                      | 21,001                                       |                                    |                | 18,898                                       |                                    |                |
| Loans, net of reserve                             | 2,903,233                                    | 61,174                             | 8.55%          | 2,220,794                                    | 43,800                             | 8.00%          |
| Total earning assets                              | 3,420,516                                    | 67,397                             | 7.99%          | 2,840,394                                    | 50,900                             | 7.27%          |
| Cash and other assets                             | 231,412                                      |                                    |                | 205,999                                      |                                    |                |
| Total assets                                      | \$ 3,651,928                                 |                                    |                | \$ 3,046,393                                 |                                    |                |
| <b>Liabilities and Stockholders Equity</b>        |  |                                    |                |  |                                    |                |
| Transaction deposits                              | \$ 105,592                                   | \$ 282                             | 1.08%          | \$ 117,685                                   | \$ 312                             | 1.08%          |
| Savings deposits                                  | 821,526                                      | 9,175                              | 4.53%          | 671,102                                      | 6,195                              | 3.74%          |
| Time deposits                                     | 769,485                                      | 9,756                              | 5.14%          | 635,250                                      | 6,664                              | 4.25%          |
| Deposits in foreign branches                      | 915,229                                      | 11,677                             | 5.17%          | 541,084                                      | 6,136                              | 4.60%          |
| Total interest bearing deposits                   | 2,611,832                                    | 30,890                             | 4.80%          | 1,965,121                                    | 19,307                             | 3.98%          |
| Other borrowings                                  | 207,303                                      | 2,559                              | 5.01%          | 350,084                                      | 3,664                              | 4.24%          |
| Debt  | 113,406                                      | 2,047                              | 7.32%          | 46,394                                       | 828                                | 7.24%          |
| Total interest bearing liabilities                | 2,932,541                                    | 35,496                             | 4.91%          | 2,361,599                                    | 23,799                             | 4.09%          |
| Demand deposits                                   | 439,071                                      |                                    |                | 445,012                                      |                                    |                |
| Other liabilities                                 | 26,494                                       |                                    |                | 19,309                                       |                                    |                |
| Stockholders equity                               | 253,822                                      |                                    |                | 220,473                                      |                                    |                |
| Total liabilities and stockholders equity         | \$ 3,651,928                                 |                                    |                | \$ 3,046,393                                 |                                    |                |
| Net interest income                               |  | \$ 31,901                          |                |  | \$ 27,101                          |                |
| Net interest margin                               |  |                                    | 3.78%          |  |                                    | 3.87%          |
| Net interest spread                               |  |                                    | 3.08%          |  |                                    | 3.18%          |



(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 | \$           | 12,068 |    | \$ | 30,748 |          |       |
| Borrowed funds      |              | 12,068 |    |    | 30,748 |          |       |
| Net interest income |              |        | \$ | 46 |        | \$ 1,854 |       |
| Net interest margin | consolidated |        |    |    | 3.77%  |          | 4.09% |
|                     |              |        | 10 |    |        |          |       |

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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 (4) Discontinued Operations.

***Summary of Performance***

We reported net income of \$7.6 million, or \$.29 per diluted common share, for the first quarter of 2007 compared to \$6.6 million, or \$.25 per diluted common share, for the first quarter of 2006. We reported net income from continuing operations of \$7.6 million, or \$.29 per diluted common share, for the first quarter of 2007 compared to \$6.9 million, or \$.26 per diluted common share, for the first quarter of 2006. Return on average equity was 12.18% and return on average assets was .84% for the first quarter of 2007, compared to 12.22% and .88%, respectively, for the first quarter of 2006. From continuing operations, return on average equity was 12.12% and return on average assets was .84% for the first quarter of 2007, compared to 12.71% and .92%, respectively, for the first quarter of 2006.

Net interest income for the first quarter of 2007 increased by \$4.8 million, or 18%, to \$31.7 million from \$26.9 million over the first quarter of 2006. The increase in net interest income was due primarily to an increase in average earning assets of \$580.1 million, or 20%, over levels reported in the first quarter of 2006.

Non-interest income increased \$1.4 million, or 37%, compared to the first quarter of 2006. The increase is primarily related to a \$946,000 increase in rental income on leased equipment from \$513,000 to \$1.5 million related to expansion of our operating lease portfolio. Trust fee income increased \$234,000 due to continued growth of trust assets.

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Non-interest expense increased \$4.0 million, or 20%, compared to the first quarter of 2006. The increase is primarily related to a \$2.8 million increase in salaries and employee benefits to \$14.6 million from \$11.8 million, of which \$1.3 million relates to an increase in FAS 123R expense. The remaining increase in salaries and employee benefits resulted from the total number of employees related to the addition of the premium finance business and general business growth. Expansion of the operating lease portfolio resulted in an increase of \$826,000 in equipment depreciation expense to \$1.2 million from \$381,000 in the first quarter of 2006.

**Net Interest Income**

Net interest income was \$31.7 million for the first quarter of 2007, compared to \$26.9 million for the first quarter of 2006. The increase was due to an increase in average earning assets of \$580.1 million as compared to the first quarter of 2006. The increase in average earning assets included a \$599.4 million increase in average loans held for investment and an increase of \$85.1 million in loans held for sale, offset by a \$100.5 million decrease in average securities. For the quarter ended March 31, 2007, average net loans and securities represented 85% and 15%, respectively, of average earning assets compared to 78% and 22% in the same quarter of 2006.

Average interest bearing liabilities increased \$570.9 million from the first quarter of 2006, which included a \$646.7 million increase in interest bearing deposits offset by a \$142.8 million decrease in other borrowings. The average cost of interest bearing liabilities increased from 4.09% for the quarter ended March 31, 2006 to 4.91% for the same period of 2007, reflecting rising market interest rates and change in funding mix.

**TABLE 1 VOLUME/RATE ANALYSIS**

(In thousands)

|                              | Three months ended March 31, 2007/2006 |                              |            |
|------------------------------|--|------------------------------|------------|
|                              | Change                                 | Change Due To <sup>(1)</sup> |            |
|                              |  | Volume                       | Yield/Rate |
| Interest income:             |  |                              |            |
| Securities <sup>(2)</sup>    | \$ (862)                               | \$ (1,133)                   | \$ 271     |
| Loans held for sale          | 1,637                                  | 1,378                        | 259        |
| Loans held for investment    | 15,737                                 | 11,789                       | 3,948      |
| Federal funds sold           | (19)                                   | (20)                         | 1          |
| Deposits in other banks      | 4                                      |                              | 4          |
| Total                        | 16,497                                 | 12,014                       | 4,483      |
| Interest expense:            |  |                              |            |
| Transaction deposits         | (30)                                   | (32)                         | 2          |
| Savings deposits             | 2,980                                  | 1,389                        | 1,591      |
| Time deposits                | 3,092                                  | 1,408                        | 1,684      |
| Deposits in foreign branches | 5,541                                  | 4,243                        | 1,298      |
| Borrowed funds               | 114                                    | (298)                        | 412        |
| Total                        | 11,697                                 | 6,710                        | 4,987      |
| Net interest income          | \$ 4,800                               | \$ 5,304                     | \$ (504)   |

(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 3.78% for the first quarter of 2007 compared to 3.87% for the first quarter of 2006. The decrease in net interest margin resulted primarily from a 72 basis point increase in the yield on earning assets while interest expense as a percentage of earning assets increased by 81 basis points.

**Non-interest Income**

Non-interest income increased \$1.4 million compared to the same quarter of 2006. The increase is primarily related to a \$946,000 increase in equipment rental income from \$513,000 to \$1.5 million related to expansion of our operating lease portfolio. Additionally, trust fee income increased \$234,000 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.

**TABLE 2 NON-INTEREST INCOME**

(In thousands)

|   | Three months ended March |         |
|---|--------------------------|---------|
|   | 2007                     | 2006    |
| Service charges on deposit accounts     | \$ 893                   | \$ 856  |
| Trust fee income                        | 1,077                    | 843     |
| Bank owned life insurance (BOLI) income | 298                      | 286     |
| Brokered loan fees                      | 479                      | 369     |
| Equipment rental income                 | 1,459                    | 513     |
| Other                                   | 930                      | 875     |
| Total non-interest income               | \$5,136                  | \$3,742 |

**Non-interest Expense**

Non-interest expense for the first quarter of 2007 increased \$4.0 million, or 19.9%, to \$24.1 million from \$20.1 million, and is primarily attributable to a \$2.8 million increase in salaries and employee benefits to \$14.6 million from \$11.8 million. The increase in salaries and employee benefits resulted from the total number of employees related to the addition of the premium finance business and general business growth.

Leased equipment depreciation for the three months ended March 31, 2007 increased by \$826,000 to \$1.2 million from \$381,000 compared to the same quarter in 2006 relating to expansion of our operating lease portfolio.

Marketing expense increased \$55,000, or 8%. Marketing expense for the three months ended March 31, 2007 included \$109,000 of direct marketing and promotions and \$431,000 for business development compared to direct marketing and promotions of \$42,000 and business development of \$355,000 during the same period for 2006. Marketing expense for the three months ended March 31, 2007 also included \$217,000 for the purchase of miles related to the American Airlines AAdvantage® program compared to \$305,000 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 March 31, 2007 increased \$209,000, or 14.4% compared to the same quarter in 2006 mainly related to growth.

**TABLE 3 NON-INTEREST EXPENSE**

(In thousands)

|                                    | Three months ended March 31 |          |
|------------------------------------|-----------------------------|----------|
|                                    | 2007                        | 2006     |
| Salaries and employee benefits     | \$14,557                    | \$11,846 |
| Net occupancy expense              | 2,020                       | 2,011    |
| Leased equipment depreciation      | 1,207                       | 381      |
| Marketing                          | 757                         | 702      |
| Legal and professional             | 1,661                       | 1,452    |
| Communications and data processing | 832                         | 692      |
| Franchise taxes                    | 41                          | 61       |

|                            |          |          |
|----------------------------|----------|----------|
| Other                      | 3,020    | 2,984    |
| Total non-interest expense | \$24,095 | \$20,129 |

**Table of Contents*****Analysis of Financial Condition***

The aggregate loan portfolio at March 31, 2007 increased \$169.5 million from December 31, 2006 to \$3.1 billion. Commercial loans increased \$85.9 million and real estate loans increased \$106.4 million. Consumer loans, loans held for sale, and leases increased \$1.7 million, \$9.1 million and \$1.7 million, respectively. Construction loans decreased \$31.0 million.

**TABLE 4 LOANS**

(In thousands)

|  | March 31,<br>2007  | December 31,<br>2006 |
|--|--------------------|----------------------|
| Commercial                                       | \$1,688,566        | \$1,602,577          |
| Construction                                     | 507,569            | 538,586              |
| Real estate                                      | 636,781            | 530,377              |
| Consumer   | 22,831             | 21,113               |
| Leases   | 46,982             | 45,280               |
| Loans held for sale                              | 208,073            | 199,014              |
| Loans held for sale from discontinued operations | 12,525             | 16,844               |
| <b>Total</b>                                     | <b>\$3,123,327</b> | <b>\$2,953,791</b>   |

We continue to lend primarily in Texas. As of March 31, 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 first quarter of 2007, the Company recorded net recoveries of loans previously charged off in the amount of \$386,000, compared to a net recovery of \$12,000 for the same period in 2006. The reserve for loan losses, which is available to absorb losses inherent in the loan portfolio, totaled \$22.6 million at March 31, 2007, \$21.0 million at December 31, 2006 and \$18.9 million at March 31, 2006. This represents 0.78%, 0.77% and 0.84% of loans held for investment (net of unearned income) at March 31, 2007, December 31, 2006 and March 31, 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 \$1.2 million provision for loan losses during the first quarter of 2007 compared to no provision in the first quarter of 2006 and \$1.0 million in the fourth quarter of 2006. Including the net recoveries, the reserve for loans losses increased by \$1.6 million for the quarter.

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.



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Qualitative adjustments for such things as general economic conditions, changes in credit policies and lending standards, and changes in the trend and severity of problem loans, can cause the estimation of future losses to differ from past experience. 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, given the significant growth in the loan and lease portfolio, current economic conditions in our market areas and other factors.

The methodology used in the periodic review of reserve adequacy, which is performed at least quarterly, is designed to be dynamic and responsive to changes in portfolio credit quality and anticipated future credit losses. The changes are reflected in the general reserve and in specific reserves as the collectibility of larger classified loans is evaluated with new information. As our portfolio matures, 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.

**Table of Contents****TABLE 5 SUMMARY OF LOAN LOSS EXPERIENCE**

(In thousands)

|   | Three<br>months<br>ended | Three months<br>ended | Year ended<br>December<br>31, |
|---|--------------------------|-----------------------|-------------------------------|
|   | March 31,<br>2007        | March 31,<br>2006     | 2006                          |
| Beginning balance   | \$21,003                 | \$ 18,897             | \$18,897                      |
| Loans charged-off:  |                          |                       |                               |
| Commercial  | 146                      |                       | 2,525                         |
| Consumer  |                          | 3                     | 3                             |
| Leases  |                          | 10                    | 76                            |
| Total   | 146                      | 13                    | 2,604                         |
| Recoveries:   |                          |                       |                               |
| Commercial  | 504                      | 4                     | 462                           |
| Consumer  | 13                       | 1                     | 1                             |
| Leases  | 15                       | 20                    | 247                           |
| Total recoveries  | 532                      | 25                    | 710                           |
| Net charge-offs (recoveries)                                    | (386)                    | (12)                  | 1,894                         |
| Provision for loan losses                                       | 1,200                    |                       | 4,000                         |
| Ending balance  | \$22,589                 | \$ 18,909             | \$21,003                      |
| Reserve to loans held for investment <sup>(2)</sup>             | .78%                     | .84%                  | .77%                          |
| Net charge-offs (recoveries) to average loans <sup>(1)(2)</sup> | (.06)%                   | (.00)%                | .08%                          |
| Provision for loan losses to average loans <sup>(1)(2)</sup>    | .18%                     |                       | .17%                          |
| Recoveries to total charge-offs                                 | 364.38%                  | 192.3%                | 27.27%                        |
| Reserve as a multiple of net charge-offs                        | N/M                      | N/M                   | 11.1x                         |
| Non-performing and renegotiated loans:                          |                          |                       |                               |
| Non-accrual   | \$ 8,843                 | \$ 6,032              | \$ 9,088                      |
| Loans past due (90 days) <sup>(3)</sup>                         | 4,828                    | 2,824                 | 2,142                         |
| Total   | \$13,671                 | \$ 8,856              | \$11,230                      |
| Other real estate owned   | \$ 89                    | \$ 89                 | \$ 882                        |
| Reserve as a percent of non-performing loans <sup>(2)</sup>     | 1.7x                     | 2.1x                  | 1.9x                          |

(1) Interim period ratios are

annualized.

- (2) Excludes loans held for sale.
- (3) At March 31, 2007, \$928,000 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 \$3.4 million in loans that were paid off in early April 2007. After giving effect to these reductions, the ratio of non-performing loans to total loans was .36% and the ratio of the reserve to non-performing loans increased to 2.2.

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

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

|                                | March 31,<br>2007 | December<br>31,<br>2006 | March 31,<br>2006 |
|--------------------------------|-------------------|-------------------------|-------------------|
|                                | (In thousands)    |                         |                   |
| Non-accrual loans:             |                   |                         |                   |
| Commercial                     | \$3,174           | \$ 5,587                | \$4,671           |
| Construction                   | 1,804             |                         |                   |
| Real estate                    | 3,705             | 3,417                   | 1,168             |
| Consumer                       | 145               | 63                      | 78                |
| Leases                         | 15                | 21                      | 115               |
| <b>Total non-accrual loans</b> | <b>\$8,843</b>    | <b>\$ 9,088</b>         | <b>\$6,032</b>    |

At March 31, 2007, we had \$4.8 million in loans past due 90 days and still accruing interest. At March 31, 2007, \$928,000 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 \$3.4 million in loans that were paid off in early April 2007. After giving effect to these reductions, the ratio of non-performing loans to total loans was .36% and the ratio of the reserve to non-performing loans increased to 2.2. At March 31, 2007, we had \$224,000 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 March 31, 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 decreased from a loss of \$8.0 million, which represented 1.49% of the amortized cost at December 31, 2006, to a loss of \$6.9 million, which represented 1.33% of the amortized cost at March 31, 2007.

The following table discloses, as of March 31, 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            | \$2,588             | \$ (3)          | \$                  | \$              | \$ 2,588   | \$ (3)          |
| Mortgage-backed securities | 401                 | (1)             | 345,537             | (7,126)         | 345,938    | (7,127)         |
| Corporate securities       |                     |                 | 30,170              | (381)           | 30,170     | (381)           |
| Municipals                 | 2,586               | (4)             | 25,863              | (281)           | 28,449     | (285)           |
| Equity securities          |                     |                 | 3,397               | (110)           | 3,397      | (110)           |
|                            | \$5,575             | \$ (8)          | \$404,967           | \$(7,898)       | \$410,542  | \$(7,906)       |

We believe the investment securities in the table above are within ranges customary for the banking industry. The number of investment positions in this unrealized loss position totals 115. 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; (2) it is not probable that we will be unable to collect the amounts contractually due; and (3) no decision to dispose of the investments was made prior to the balance sheet date. 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 three months ended March 31, 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 March 31, 2007, comprised \$3,080.9 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 March 31, 2007, brokered retail CDs comprised \$5.8 million, or 0.2%, of total deposits. We believe the Company has access to sources of brokered deposits of not less than \$800 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), securities sold under repurchase agreements, treasury, tax and loan notes, and advances from the FHLB. As of March 31, 2007, our borrowings consisted of a total of \$42.5 million of securities sold under repurchase agreements, \$105.0 million of upstream federal funds purchased and \$183.6 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 March 31, 2007, we had no borrowings from

the FHLB. FHLB borrowings are collateralized by eligible securities and loans. Our unused FHLB borrowing capacity at March 31, 2007 was approximately \$580.0 million. As of March 31, 2007, we had unused upstream federal fund lines available from commercial banks of approximately \$379.5 million. During the three months ended March 31, 2007, our average other borrowings from these sources were \$207.3 million, of which \$43.0 million related to securities

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sold under repurchase agreements. The maximum amount of borrowed funds outstanding at any month-end during the first three months of 2007 was \$331.1 million, of which \$42.5 related to securities sold under repurchase agreements. Our equity capital averaged \$253.8 million for the three months ended March 31, 2007 as compared to \$220.5 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.

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**

|                     | March 31,<br>2007 | March 31,<br>2006 |
|---------------------|-------------------|-------------------|
| Risk-based capital: |                   |                   |
| Tier 1 capital      | 9.84%             | 9.61%             |
| Total capital       | 11.13%            | 10.30%            |
| Leverage            | 9.50%             | 8.60%             |

As of March 31, 2007, our significant fixed and determinable contractual obligations to third parties were as follows:

| (In thousands)                                     | Within<br>One Year | After One<br>but<br>Within<br>Three<br>Years | After<br>Three<br>but Within<br>Five Years | After Five<br>Years | Total        |
|--|--------------------|--|--|---------------------|--------------|
| Deposits without a stated maturity<br>(1)          | \$ 1,421,574       | \$   | \$   | \$                  | \$ 1,421,574 |
| Time deposits (1)                                  | 1,536,614          | 108,771                                      | 19,716                                     | 62                  | 1,665,163    |
| Federal funds purchased (1)                        | 288,640            |  |  |                     | 288,640      |
| Securities sold under repurchase<br>agreements (1) | 29,400             |  |  |                     | 29,400       |
| Customer repurchase agreements (1)                 | 13,078             |  |  |                     | 13,078       |
| Operating lease obligations                        | 5,770              | 13,232                                       | 8,861                                      | 35,495              | 63,358       |
| Debt (1)   |                    |  |  | 113,406             | 113,406      |
| Total contractual obligations                      | \$ 3,295,076       | \$ 122,003                                   | \$ 28,577                                  | \$ 148,963          | \$ 3,594,619 |

(1) Excludes  
interest

**Off-Balance Sheet Arrangements**

The contractual amount of our financial instruments with off-balance sheet risk expiring by period at March 31, 2007 is presented below:

| (In thousands)               | Within<br>One<br>Year | After One<br>but Within<br>Three<br>Years | After<br>Three<br>but Within<br>Five Years | After<br>Five<br>Years | Total        |
|------------------------------|-----------------------|---|--|------------------------|--------------|
| Commitments to extend credit | \$ 575,745            | \$ 452,457                                | \$ 76,248                                  | \$ 11,096              | \$ 1,115,546 |



|   |            |            |           |           |              |
|---|------------|------------|-----------|-----------|--------------|
| Standby letters of credit                               | 60,157     | 47         |           |           | 60,204       |
| Total financial instruments with off-balance sheet risk | \$ 635,902 | \$ 452,504 | \$ 76,248 | \$ 11,096 | \$ 1,175,750 |

Due to the nature of our unfunded loan commitments, including unfunded lines of credit, the amounts presented in the table above do not necessarily represent amounts that we anticipate funding in the periods presented above. See Note (3) Financial Instruments With Off-Balance Sheet Risk in Item I herein.

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**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 March 31, 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****March 31, 2007**

(in thousands)

|                                      | <b>0-3 mo<br/>Balance</b> | <b>4-12 mo<br/>Balance</b> | <b>1-3 yr<br/>Balance</b> | <b>3+ yr<br/>Balance</b> | <b>Total<br/>Balance</b> |
|--------------------------------------|---------------------------|----------------------------|---------------------------|--------------------------|--------------------------|
| Securities <sup>(1)</sup>            | \$ 24,890                 | \$ 68,089                  | \$ 156,114                | \$ 259,203               | \$ 508,296               |
| Total variable loans                 | 2,555,301                 | 30,466                     | 638                       | 1,142                    | 2,587,547                |
| Total fixed loans                    | 157,901                   | 106,719                    | 166,806                   | 104,354                  | 535,780                  |
| Total loans <sup>(2)</sup>           | 2,713,202                 | 137,185                    | 167,444                   | 105,496                  | 3,123,327                |
| Total interest sensitive assets      | \$ 2,738,092              | \$ 205,274                 | \$ 323,558                | \$ 364,699               | \$ 3,631,623             |
| Liabilities:                         |                           |                            |                           |                          |                          |
| Interest bearing customer deposits   | \$ 1,871,641              | \$                         | \$                        | \$                       | \$ 1,871,641             |
| CD s & IRA s                         | 259,633                   | 318,481                    | 103,706                   | 19,778                   | 701,598                  |
| Wholesale deposits                   | 657                       | 4,986                      | 169                       |                          | 5,812                    |
| Total interest-bearing deposits      | 2,131,931                 | 323,467                    | 103,875                   | 19,778                   | 2,579,051                |
| Repo, FF, FHLB borrowings            | 319,918                   | 11,200                     |                           |                          | 331,118                  |
| Trust preferred                      |                           |                            |                           | 113,406                  | 113,406                  |
| Total borrowing                      | 319,918                   | 11,200                     |                           | 113,406                  | 444,524                  |
| Total interest sensitive liabilities | \$ 2,451,849              | \$ 334,667                 | \$ 103,875                | \$ 133,184               | \$ 3,023,575             |
| GAP                                  | 286,243                   | (129,393)                  | 219,683                   | 231,515                  |                          |
| Cumulative GAP                       | 286,243                   | 156,850                    | 376,533                   | 608,048                  | 608,048                  |
| Demand deposits                      |                           |                            |                           |                          | \$ 507,686               |
| Stockholders equity                  |                           |                            |                           |                          | 263,616                  |
| Total                                |                           |                            |                           |                          | \$ 771,302               |

(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 March 31, 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 savings accounts) for a given level of market rate changes. These assumptions have been developed through a

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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 |
|                               | March 31, 2007                                 | March 31, 2007  |
| Change in net interest income | \$ 9,102                                       | \$ (9,271)      |

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 March 31, 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 and 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: May 3, 2007

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