Condition of the Texas State Banking System

A Report to the Finance Commission of Texas

September 30, 2008

Prepared by:
Texas Department of Banking
Texas Department of Savings and Mortgage Lending

Financial Data as of June 30, 2008

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Key for Symbols Used Throughout this Report:	**Abbreviations Used Throughout this Report**:
⇧ Improving or strong conditions ⇩ Deteriorating or weak conditions ⇳ Mixed conditions ❖ Interest item	FDIC - Federal Deposit Insurance Corporation OCC - Office of the Comptroller of the Currency FRB - Federal Reserve Board OTS - Office of Thrift Supervision

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ECONOMIC REVIEW AND OUTLOOK
STATE BANKING SYSTEM OF TEXAS

BANKING SYSTEM OVERVIEW

The Texas economy expanded modestly despite the weakening national economy and on-going problems in the financial markets. Oil and gas prices have positively influenced the economy in Texas. Operating results for June 2008 reflect a profitable year thus far for Texas commercial banks and savings institutions, with steady loan and deposit growth during the year despite increased competition and national concerns of the fallout from the subprime mortgage crisis and other disruptions in the financial markets. Texas banks are better capitalized than U.S. banks as a whole, and have been able to better absorb the impact of the disruptions.

A summary of important performance ratios continues to show mixed results for the state's banking system. The percentage of unprofitable state-chartered and federally-chartered banks increased to 12.33% as of June 30, 2008, up significantly from 7.20% in June 2007.

For thrifts the change was more significant from previous reports as 36.73% are now unprofitable, compared to 11.90% in June 2007. Net interest margins (NIM) for banks and thrifts remained acceptable despite an increase in the cost of funds for the year. Banks reported a NIM of 3.66%, down from 4.21% in 2007. Thrifts' NIM was 2.68% in June 2008, down slightly from 2.79% in 2007. The return on assets for banks dropped during the first two quarters of 2008 to 0.90%, from 1.27%, while the return on assets for thrifts dropped more significantly from 0.99% in June 2007 to a negative 0.36% in June 2008.

Mid-year totals for the number of Texas state-chartered banks and thrifts reflect an increase of two institutions over June 2007. De novo charter and conversion activity has recently started to increase after a short lull at the end of 2007. The combined assets of state and federally chartered banks and savings institutions operating in Texas totaled $613.2 billion as of June 2008, an increase of $179.5 billion from June 2007. Texas state-chartered banks and savings institutions accounted for $185.3 billion of the total assets in June 2008, or 30%. This is a significant increase over June 2007, with total assets up $72.9 billion.

TEXAS ECONOMIC PROFILE

Although not as strong as it was at year-end 2007, the Texas economy continued to outperform the rest of the nation. As the 12th largest economy in the world, it is not foreseen that Texas will slip into a recession, unless national stress accelerates and deepens.

Texas' gain of approximately 252,000 jobs in a 12 month period ending August 2008 more than any other state. The unemployment rate increased slightly, but remains below that of the national rate. In the last year, 45% of employment gains for the nation are attributed to Texas. As energy prices have risen, so has the activity in the oil and gas industry, benefiting our economy with additional job creation.

Generally, Texas has not been significantly impacted by the national real estate crunch, and home values remain stable. Existing home sales are showing signs of deceleration; however, prices remain steady. Permits for new homes have also decreased. There are some concerns that lending standards have become too stringent, thus making it difficult for credit worthy individuals to obtain mortgage loans. Other parts of the nation are experiencing more severe credit restrictions. Many of these potential home buyers are left to look at the apartment market to meet their needs. Foreclosures in Texas remain stable compared to other states, with only one in every 849 homes being foreclosed upon. Foreclosures rates in other states include Nevada's one in 91; California's one in 130; and Arizona's one in 182.

Consumers have been affected by the higher fuel prices, however, with the changes in driving habits, the state is also benefiting. More consumers are opting to travel shorter distances and stay within the state. Reports show that state parks have exhibited an increase in attendance, which is being attributed to the rising fuel cost. Consumer confidence remains fairly strong at 93 versus 38 in the Rust Belt region.

The Texas manufacturing industry continued to soften through early 2008 as demand for materials to supply residential construction weakened. Retail remained unchanged, however automobiles sales weakened with no improvement being anticipated until next year. Discount retailers in Texas showed stronger sales even though the economy was less robust. The financial services sector reported satisfactory conditions, despite the uncertain financial environment. The outlook for Texas remains generally positive for the remainder of 2008 and the state economy is expected to remain stronger than the national economy.

The caveat to this forecast hinges on a quick solution addressing national and world credit market issues.

SUPERVISORY CONCERNS

The Texas Department of Banking and the Texas Savings and Mortgage Lending Department continues to closely monitor events in Washington to reach an agreement on a plan to provide market stability by assisting financial institutions through the purchase of troubled assets. Though the state banking system is considered sound and most Texas banks did not participate in the high risk lending practices or the securitization of loans that are now the subject of so much controversy, Texas banks could be impacted by a general slowdown in the economy or other markets factors that could develop if an agreement is not reached.

Although the pace of growth may slip further in the second half of 2008, the Texas economy is expected to continue to outperform the nation. Consumer confidence has been in a decline since late 2007, and reports indicate that we are at the lowest level since the early 1980s. This plunge is troublesome because it suggests that Texans are feeling the pinch of a slowing economy and higher commodity prices, which may result in cut backs on discretionary expenditures. Further concerns arise with the most recent news of the financial market turbulence and the government's involvement in trying to stabilize the situation. Texas financial institutions are fortunate to have many Presidents and Chief Executive Officers that remember the economic stresses that crippled the state 20 years ago and have been adamant in operating their institutions prudently and safely. They adhere to sound loan underwriting standards, realize the benefits of diversification, work hard to acquire core or reliable funding sources, and maintain sound operational controls and safeguards.

During a weak economic climate, liquidity is critical to the solvency of a distressed financial institution and system. If a financial institution maintains strong asset quality, earnings, and capital but is unable to satisfy its liquidity needs, it runs the risk of failure. The Federal Reserve has responded by easing the monetary policy, and taking a number of steps aimed at reducing funding pressures for financial institutions to improve overall market liquidity and market functioning. Despite an increase in inflationary pressures, the Federal Open Market Committee (FOMC) has maintained a relatively low target for the federal funds rate. The Fed is offering liquidity support to the financial markets through a variety of reserve programs. They are cooperating with other regulators to monitor the health of individual financial institutions; working with the private sector to reduce risks in some key markets; developing new regulations, including new rules to govern mortgage and credit card lending; and taking an active part in domestic and international efforts. Both agencies understand that liquidity management in banks and thrifts varies based on the size and sophistication of the institution and the nature and complexity of its activities and must be continually monitored, not just during times of stress.

A few banks holding government-sponsored enterprises' (GSE) preferred stock are seeking some type of regulatory relief after Fannie and Freddie were put into conservatorship on September 7, 2008, and the value of preferred stock tumbled. Financial institution writedowns can only be treated as capital gains losses for tax purposes. Community banks do not experience many opportunities for capital gains, and therefore their losses effectively are not recognized for tax purposes. Another concern is that Fannie Mae small home lenders could have a tougher time now that Fannie Mae has tightened its eligibility requirements for purchasing loans and servicers. The new standards for doing business with Fannie Mae cover such things as minimum net worth and capital ratios.

The Texas Department of Banking has contacted its regulated financial institutions that have been identified through call report information as holding Fannie/Freddie preferred stock. Of the institutions we have been in contact with, two would be significantly affected, placing them in an undercapitalized situation, requiring them to establish a recapitalization plan. The Department continues to monitor this situation and discuss corrective actions with the affected institutions.

Proposed federal legislation aimed at restoring the confidence in GSEs sets forth the creation of a facility that would buy and hold up to $700 billion in troubled assets. The proposal does not clearly define who could sell to the facility; what assets it would buy; how Treasury would determine the price of such assets; and accounting implications for banks that use the facility. Recommendations have been made to revise the proposal to better define what types of financial institutions will be eligible to sell loans to the facility. It is difficult to forecast the degree to how smaller financial institutions will be affected by this proposal.

Other crucial elements of strong liquidity management are strong analysis of funding requirements under alternative scenarios, diversification of funding sources, and contingency planning. Given the natural disasters that have impacted the state over the years and most recently Hurricane Gustav and Ike, it is considered prudent for bankers to review their emergency contingency plans such as operational and contingent funding plans, particularly those who rely substantially on wholesale funds. Supervisors will remain alert to emerging trends.

The Texas housing market has not had values swing to the same levels as other states. Trends show that the Texas housing market is cooling off, but at a slower pace than other parts of the nation. Consumer spending is affected by a weakening economy, which will cause some borrowers to experience difficulties in their ability to repay debt, resulting in higher past due and default rates. Taken all together, competition for quality consumers will require Texas bankers to exercise higher levels of diligence in all banking activities to ensure prudent decisions are made and sound practices followed.

Deterioration in bank performance typically lags behind unfavorable conditions as the effects of economic pressures on bank borrowers can be concealed for months. Consequently, bank and thrift supervisors must continue to look ahead for potentially damaging factors that may weaken borrowers' repayment ability and subsequently erode the asset quality of financial institutions. Financial institutions that recognize these factors early and are quick to respond can dramatically improve their chances to minimize the loss exposure. However, if problem loans are not identified in a timely manner, or interest rate risk is not properly managed, then failure could result if these conditions go unchecked.

Other issues that remain a supervisory concern include: corporate governance; bank holding company strength; Bank Secrecy Act and USA Patriot Act compliance; identity theft; fraud; and home equity lending. Supervisors will remain alert to recognize significant changes in the areas described above and initiate prompt corrective action for those institutions that are unable to monitor and manage these threatening circumstances.

SUPERVISORY MEASURES BEING TAKEN BY THE DEPARTMENT OF BANKING

Despite continuing merger activity, the number of Texas state banks as of June 30, 2008, was 328, the same as a year earlier. Banks lost to mergers were replaced by Texas Security Bank, Dallas, Memorial City Bank, Houston, and Collin Bank, Frisco, all of which opened in the first half of 2008. Bank numbers will continue to increase with the opening of new charter Liberty Capital Bank, Addison, and the conversions of Snyder National Bank, Snyder, and Fidelity Bank, N.A., Plano, in the second half of the year. In addition, there are six new charter applications in various stages of processing which should open either this year, or early in 2009.

Texas state bank assets over the first half of the year exhibited a small decline from $154.3 billion to $153.9 billion. However, this includes the merger-out in March, 2008, of the $8.5 billion Texas State Bank, McAllen, which reflects relatively healthy growth in the remaining banks. Of particular note as a contributor to this growth was the acquisition by Happy State Bank, Happy, of 10 Amarillo-area branches of Citibank, N.A., involving about $260 million.

The Department strives to be responsive to catastrophic events, like Hurricane Ike, economic conditions, including the news about Fannie Mae and Freddie Mac (FNMA/FHLMC), Lehman Brothers and AIG. All these events influence the Department's actions. The supervisory practices of the agency are designed to identify trends in the industry as a whole, and practices of individual banks that could threaten the safety and soundness of an institution or the industry. Problem status can sometimes be prevented, or a quick turnaround implemented, by timely regulatory identification and positive management response.

The number of problem institutions is considered manageable. Although the majority of institutions are meeting the current economic challenges, the number of problem financial institutions will increase if the economy continues to stall and consumer spending drop.

The Department continues to closely monitor and identify concerns surrounding the stability of our financial institutions and is sensitive to identifying individual banks that demonstrate difficulty. Examiners will review institutional exposure to the changing economic conditions and take action to limit risk, when necessary.

The Department's staff is performing the following:

- Frequent conference calls with other state and federal regulators;
- Monthly calls to state banks to obtain industry input on prevailing economic conditions;
- On-site bank visitations by Regional Directors to discuss industry related issues in a non-examination environment;
- Revising bank examination review procedures with a greater focus on risk assessment;
- Monitoring and evaluating asset concentrations, liquidity, and funding sources;
- Increasing scrutiny of bank contingency plans that may be implemented during a catastrophic event;
- Internal monitoring of state, national, and world political and economic events impacting the industry such as Lehman Brothers, FNMA/FHLMC, AIG and other bailouts and major financial market changes;
- Increasing review of compliance with Bank Secrecy Act and USA Patriot Act provisions;
- Enhancing assessment of information technology security risks; and
- Increasing internal communication for examiner awareness of issues.

SUPERVISORY MEASURES BEING TAKEN BY THE DEPARTMENT OF SAVINGS AND MORTGAGE LENDING

State-chartered thrift assets under the Department's jurisdiction totaled $9.14 billion as of June 30, 2008, and decreased by 8.1% or $810.0 million from December's 2007 adjusted balance of $9.95 billion. The total number of state chartered savings banks at June 30, 2008 is twenty-seven, increasing by a net total of one since December 2007. Year-to-date, two additional charters have been added; one through conversion from a state bank, Colorado Valley Bank, La Grange, to Colorado Valley Bank ssb, effective January 29, 2008; and one *de novo* charter, Third Coast Bank, SSB, Humble – Houston, effective February 25, 2008. Beal Bank, ssb left the state chartered system, converting to a federal thrift now known as Beal Bank, effective February 1, 2008.

One other charter conversion application has been completed since June 30, 2008: The Bank of Crowley, a state charter and nonmember of the Federal Reserve converted on September 15, 2008 to a savings bank now known as Texas Exchange Bank, SSB. Two additional charter applications remain under review and in process: (1) a conversion application, filed June 25, 2008 from the First Bank of Snook, Snook, ("Snook"), a state commercial bank and member of the Federal Reserve through an acquisition, by acquirer ST Financial Group, a Texas corporation, of Snook Bancshares, Inc., that wholly owns Snook, into a state savings bank to be known as the Spirit of Texas, SSB, [the transaction also involves a relocation of the bank's home office from Snook to College Station and the establishment of a new branch in Magnolia] and, (2) a *de novo* application from One Earth Bank, SSB, Austin, Texas filed September 16, 2008.

Discussions continue to be held with several potential *de novo* applicants and/or charter conversions. The total industry is projected to remain at the current level in number and in total assets; however, several state savings banks could have the potential for asset contraction.

The Departments' supervisory monitoring and enforcement staff will:

- Regular conference calls and close coordination with other state and federal regulators;
- Quarterly analysis of Call Report financial data including telephone inquiries of thrift management for explanation of unusual items and variation in quarterly operating results;
- Off-site monitoring of each institution's activity (i.e., regulatory correspondence and approvals, independent audit reports, reports of examination, and institution responses to examination comments, criticisms and recommendations);
- Joint review by the FDIC and the Department of savings bank's contingency / disaster recovery plans. During and after Hurricane Ike, daily conference calls were held by state and federal regulators with frequent (in some circumstances daily) contact between the Department and affected institutions;
- Regular assessments of each institution's activities, strengths and weaknesses, and revising the Department's plan of examination and monitoring for the institution, including the downgrading of institutions if deemed necessary by the Department and the FDIC;
- Monitoring increased foreclosure activity and changes in the housing market;
- Working with various community groups on foreclosure prevention / education;
- Reviewing concentrations in commercial real estate and monitor with Commercial Real Estate Lending Joint Guidance, issued December 12, 2006; and,
- Internal monitoring of local, state, national and world political and economic events impacting the industry, including recent events regarding FNMA/FHLMC, AIG and other bailouts and major financial market changes.

PERFORMANCE SUMMARY AND PROFILE
TEXAS BANKING SYSTEM

Texas state-chartered banks, overall, continue to fare better than banks in other states. For June 30, 2008, they show a leverage (core) capital ratio of 9.02% and a loss allowance to total loans of 1.17%. There has been an increase in the percentage of unprofitable institutions to 14.94% from 8.84% the same time last year, but there also have been eight new institutions open in the last 12 months and historically they take 24 to 36 months to become profitable.

The financial stresses have increased the number of bad loans for financial institutions. The trend of noncurrent, or past due loans, as a percent of total loans, exhibited by state-chartered banks in the first two quarters of 2008 reinforces that asset quality is weak. In June 2008, bank's noncurrent loans to loans were 1.30%, as opposed the 0.57% posted one year earlier. Thrifts noncurrent loans to loans increased to 7.63% at June 2008, from 2.21% in June 2007. Bank's noncurrent assets plus other real estate owned to total assets increased 58 basis points to 1.03% for banks. Thrifts increased substantially more with an increase of 384 basis points to a total of 6.04% at June 2008 in noncurrent loans plus other real estate owned to total assets. Principally excluding a thrift institution with significant out of state lending results in a reduction of noncurrent loans of 116 basis points to 1.74% of gross loans at June 2008.

Earnings eroded as the return on assets (ROA) for state-chartered banks decreased to 0.90% in June 2008 from 1.22% at year-end. While this performance ratio is not as good as last year, it remains acceptable considering the economic stresses in some parts of the state. Earnings have been affected in part by requirements from federal regulators to have higher reserves for the anticipated systemic weaknesses in the banking industry. Texas banks continue to show resistance to adverse economic trends that have affected other parts of the United States primarily, especially since the Texas economy has outperformed the nation in those areas.

ROA for thrifts decreased to a negative 2.87% in June 2008 from 0.57% at year-end, again primarily from a thrift's impairment of goodwill; the compression of the net interest margin, charge-offs and additional loan and lease loss provisions losses. When excluding this institution, ROA declined to a positive 0.44% compared to 2.67% at year-end 2007. Further considering the exit of one thrift charter from the state system after year-end, adjusted ROA for year-end would have been 0.86%, with the reduction primarily due to a decreased net interest margin. Thrift interest income, as a percentage of average assets, dropped 159 basis points from December 31, 2007. Interest expense to average assets also decreased 32 basis points, resulting in a net decrease of interest income of 127 basis points. Total noninterest income reduced 23 basis points from year-end, while noninterest expenses have increased by 140 basis point as a percent of average assets (impacted by goodwill impairment).

Economic stresses continue to squeeze net interest margins for financial institutions. State-chartered banks margins dropped 36 basis points from year-end to 3.66%, while thrifts declined by 142 basis points to 2.39%. This can be attributed to several factors, including bad loans, lower yields, and increased loan loss reserves. Year to date provisions to the allowance for loan losses in December 2007 of $332 million increased to $433 in June 2008 for banks, and thrifts likewise increased during the same period from $63 million to $73 million. Some of the increase in the provision is attributed to one large financial institution with branches in other markets outside of Texas who is taking additional precautions.

Loss reserves appear to be adequate for both banks and thrifts; however, this position is contingent upon economic conditions. Reserves now represent 1.17% of loans for banks and 1.42% for savings institutions. This is a slight increase for state banks with a 25 basis point rise for savings institutions since December 2007. Net loan charge-offs increased significantly from year-end. Net charge-offs increased dramatically for thrifts, from $18 million at December 2007, with 48% of net charge-offs related to 1-4 single family residential loans (SFR); 28% to construction and land development (C&D); and, 13% to other loans, to $60 million at June 2008 with 46% related to SFR and 38% to C&D, and banks. However, given the current economic conditions, the overall charge-off levels for both banks and thrifts are not unreasonable.

Capital protection decreased slightly in the first six months of 2008; however, it continues to exceed the highest regulatory capital standards. State banks experienced a 31 basis point decrease in their leverage capital ratio of 9.02%, while thrifts experienced a larger decrease of 378 basis points from 11.54% to 7.76% primarily due to two large thrifts. Excluding such thrifts results in a decline of 65 basis points to a ratio of 11.12% for the remaining thrift industry.

Number of Institutions and Total Assets

	6-30-2008 No. of Institutions	6-30-2008 Assets	6-30-2007 No. of Institutions	6-30-2007 Assets	Difference No. of Institutions	Difference Assets
Texas State-Chartered Banks	328	$153.9	328	$86.7	+0	+$67.2
Texas State-Chartered Thrifts	27	$9.1	22	$9.4	+5	-$0.3
	355	$163.0	350	$96.1	+5	+$66.9
Other states' state-chartered:						
Banks operating in Texas*	20	$22.3	17	$16.3	+3	+$6.0
Thrifts operating in Texas*	0	0	0	0	0	0
	20	$22.3	17	$16.3	+3	+$6.0
Total State Chartered Activity	375	$185.3	367	$112.4	+8	+$72.9
National Banks Chartered in Texas	272	$104.3	283	$99.3	-11	+$5.0
Federal Thrifts Chartered in Texas	22	$84.5	20	$68.3	+2	+$16.2
	294	$188.8	303	$167.6	-9	+$21.2
Other states' federally-chartered:						
Banks operating in Texas*	20	$164.1	19	$143.9	+1	+$20.2
Thrifts operating in Texas*	12	$75.0	10	$9.8	+2	+$65.2
	32	$239.1	29	$153.7	+3	+$85.4
Total Federally-Chartered Activity	326	$427.9	332	$321.3	-6	+$106.6
Total Banking/Thrift Activity	701	$613.2	699	$433.7	+2	+$179.5

Assets in Billions
**Indicates estimates based on available FDIC information.*

Ratio Analysis

As of June 30, 2008

Number of Banks-------------------------→	*State-Chartered Banks* 328	*Texas National Banks* 272	*All Texas Banks* 600	*State-Chartered Thrifts* 27	*Texas Federal Thrifts* 22	*All Texas Thrifts* 49
% of Unprofitable Institutions	14.94%	9.19%	12.33%	37.04%	36.36%	36.73%
% of Institutions with Earnings Gains	43.29%	52.21%	47.33%	33.33%	36.36%	34.69%
Yield on Earning Assets	5.97%	6.38%	6.13%	6.09%	5.55%	5.60%
Net Interest Margin	3.66%	4.16%	3.86%	2.39%	2.71%	2.68%
Return on Assets	0.90%	1.251%	1.04%	-2.87%	-0.08%	-0.36%
Return on Equity	8.92%	11.16%	9.89%	-28.99%	-1.06%	-4.56%
Net Charge-offs to Loans	0.53%	0.24%	0.42%	1.99%	1.06%	1.16%
Earnings Coverage of Net Loan C/Os	4.68%	12.22%	6.34%	-1.37%	2.25%	1.59%
Loss Allowance to Loans	1.17%	1.15%	1.16%	1.42%	1.92%	1.86%
Loss Allowance to Noncurrent Loans	90.23%	169.75%	110.10%	18.64%	80.85%	63.34%
Noncurrent Assets+OREO to Assets	1.03%	0.62%	0.86%	6.04%	1.55%	1.98%
Net Loans and Leases to Core Deps	126.42%	102.71%	115.97%	113.59%	127.05%	125.43%
Equity Capital to Assets	9.90%	11.06%	10.37%	8.93%	7.66%	7.78%
Core Capital (Leverage) Ratio	9.02%	8.95%	8.99%	7.76%	8.15%	8.11%

Data for other state chartered institutions doing business in Texas is not available and therefore excluded.

Comparison Report

Select Balance Sheet and Income/Expense Information

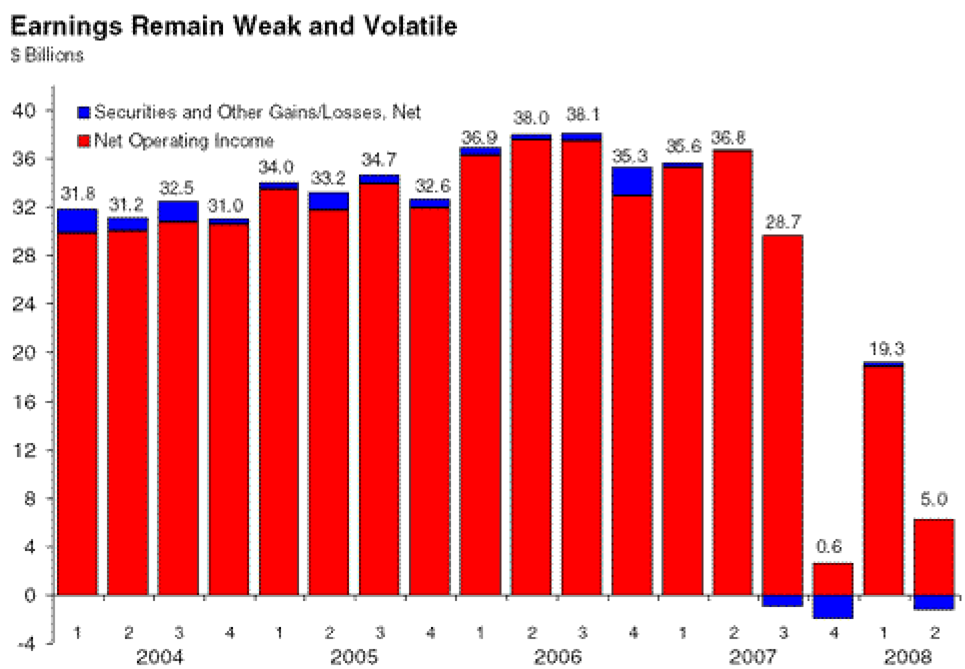
As of June 30, 2008

	State Banks*		State Thrifts	
	End of Period	*% of Total Assets*	End of Period	*% of Total Assets*
Number of Institutions	328		27	
Number of Employees (full-time equivalent)	35,682		1,655	
(In millions)				
Total Assets	$153,892		$9,144	
Net Loans and Leases	$104,983	68.22%	$5,999	65.61%
Loan Loss Allowance	$1,244	0.81%	$87	0.95%
Other Real Estate Owned	$202	0.13%	$90	0.98%
Goodwill and Other Intangibles	$2,019	1.31%	$135	1.47%
Total Deposits	$110,916	72.07%	$6,408	70.08%
Federal Funds Purchased and Repurchase Agreements	$4,864	3.16%	$33	0.36%
Other Borrowed Funds	$180,257	11.86%	$1,776	19.42%
Equity Capital	$15,237	9.90%	$817	8.93%
Memoranda:				
Noncurrent Loans and Leases	$1,379	0.90%	$464	5.08%
Earning Assets	$138,632	90.08%	$8,190	89.57%
Long-term Assets (5+ years)	$28,173	18.31%	$2,396	26.21%
	Year-to Date	*% of Avg. Assets*	Year-to Date	*% of Avg. Assets*
Total Interest Income	$4,055	5.39%	$245	5.40%
Total Interest Expense	$1,568	2.08%	$149	3.28%
Net Interest Income	$2,487	3.30%	$96	2.12%
Provision for Loan and Lease Losses	$433	0.57%	$73	1.62%
Total Noninterest Income	$987	1.31%	$20	0.43%
Total Noninterest Expense	$2,189	2.91%	$198	4.38%
Securities Gains	$58	0.08%	$2	0.04%
Net Income	$675	0.90%	-$130	-2.87%
Memoranda:				
Net Loan Charge-offs	$274	0.36%	$60	1.33%
Cash Dividends	$395	0.52%	$6	0.13%

* *Excludes branches of state-chartered banks of other states doing business in Texas. As of 6-30-08 an estimate is twenty institutions with $22.3 billion in assets. No branches of state-chartered thrifts of other states conducted business in Texas as of 6-30-08.*

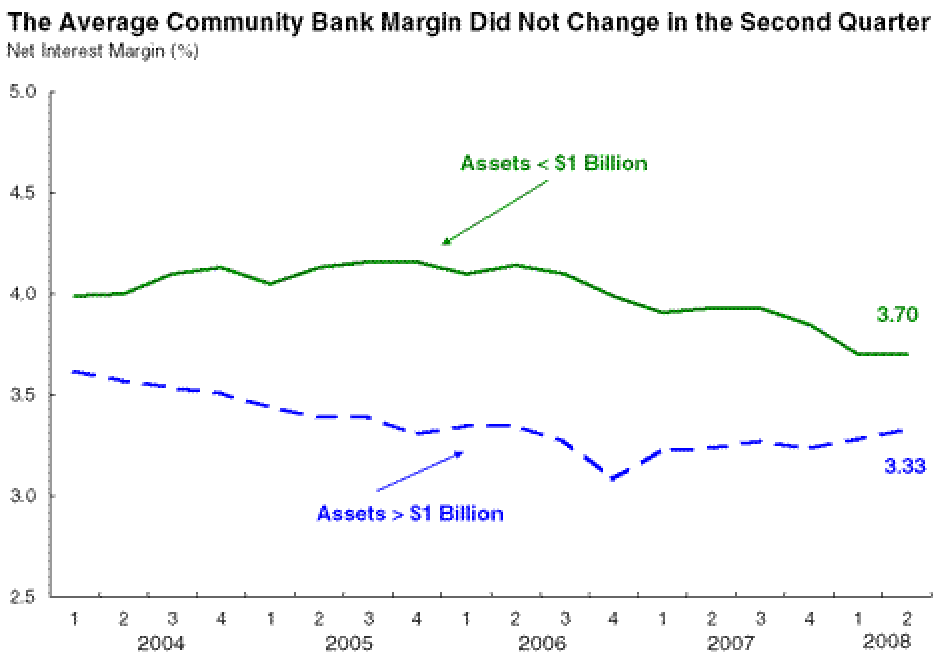
Quarterly Banking Profile – National Level
Second Quarter 2008
Federal Deposit Insurance Corporation

⇩ **Earnings Performance** - The continued downturn in the credit cycle, combined with lingering weakness in financial markets and falling asset values, had a pronounced negative effect on banking industry performance in the second quarter. Insured commercial banks and savings institutions reported net income of $5.0 billion for the second quarter of 2008. This is the second-lowest quarterly total since 1991 and is $31.8 billion (86.5 percent) less than the industry earned in the second quarter of 2007. Higher loan-loss provisions were the most significant factor in the earnings decline. Loss provisions totaled $50.2 billion, more than four times the $11.4 billion quarterly total of a year ago. Second-quarter provisions absorbed almost one-third (31.9 percent) of the industry's net operating revenue (net interest income plus total noninterest income), the highest proportion since the third quarter of 1989. A year ago, provisions absorbed only 7.3 percent of industry revenue. The average return on assets (ROA) in the second quarter was 0.15 percent, compared to 1.21 percent a year earlier. Large institutions as a group had more substantial earnings erosion than smaller institutions, but downward earnings pressure was widely evident across the industry. At institutions with assets greater than $1 billion, the average ROA in the second quarter was 0.10 percent, down from 1.23 percent a year ago. At institutions with less than $1 billion in assets, the average second-quarter ROA was 0.57 percent, compared to 1.10 percent in the second quarter of 2007. More than half of all insured institutions (56.4 percent) reported year-over-year declines in quarterly net income, and almost two out of every three institutions (62.1 percent) reported lower ROAs. Almost 18 percent of all insured institutions were unprofitable in the second quarter, compared to only 9.8 percent in the second quarter of 2007.

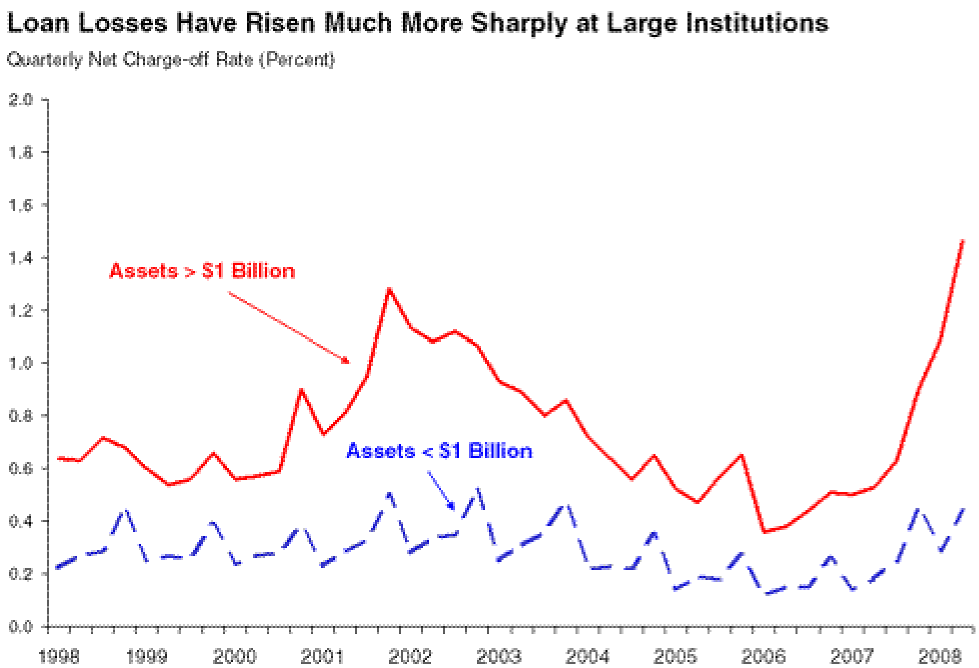


⇩ **Market-Sensitive Revenues** - Net operating revenue was only $772 million (0.5 percent) above the level of a year earlier, even though revaluations of certain assets and liabilities under fair value accounting provided a $7.9-billion boost to pretax earnings in the second quarter. Noninterest income of $60.8 billion was $7.4 billion (10.9 percent) lower than in the second quarter of 2007. The decline in noninterest income was attributable to lower trading income (down $5.5 billion, or 88.6 percent); smaller gains from sales of loans, foreclosed properties, and other assets (down $1.7 billion, or 41.2 percent); and lower income from securitization activities (down $1.5 billion, or 28.3 percent). In addition to the decline in noninterest income, securities sales yielded $2.3 billion in net losses in the second quarter, compared to $573 million in net gains a year earlier. Expenses for goodwill and other intangibles totaled $4.5 billion, more than double the $2.1 billion incurred by the industry in the second quarter of 2007. Net interest income was one of the few bright spots in industry revenues, rising by $8.2 billion (9.3 percent) over year-earlier levels. Servicing fee income increased by $1.9 billion (35.9 percent). Service charges on deposit accounts increased by $853 million (8.6 percent) at insured commercial banks and state-chartered savings banks.

⇩ **Net Interest Margins** - The average net interest margin (NIM) improved slightly compared to the first quarter, from 3.33 percent to 3.37 percent. Improvements and declines were fairly evenly divided among insured institutions, with 46.9 percent reporting lower margins than in the first quarter, and 51.5 percent reporting improved NIMs. The relatively small change in quarterly NIM contrasted with declines of more than 50 basis points in both average asset yields and average funding costs between the two quarters. The average yield on interest-bearing assets fell from 6.27 percent in the first quarter to 5.76 percent in the second quarter, while the average interest expense to fund interest-bearing assets fell from 2.95 percent to 2.38 percent. The industry average NIM has remained within a 5 basis-point range during the last six quarters, as community bank margins have fallen by 21 basis points and margins for larger institutions have risen by 10 basis points.



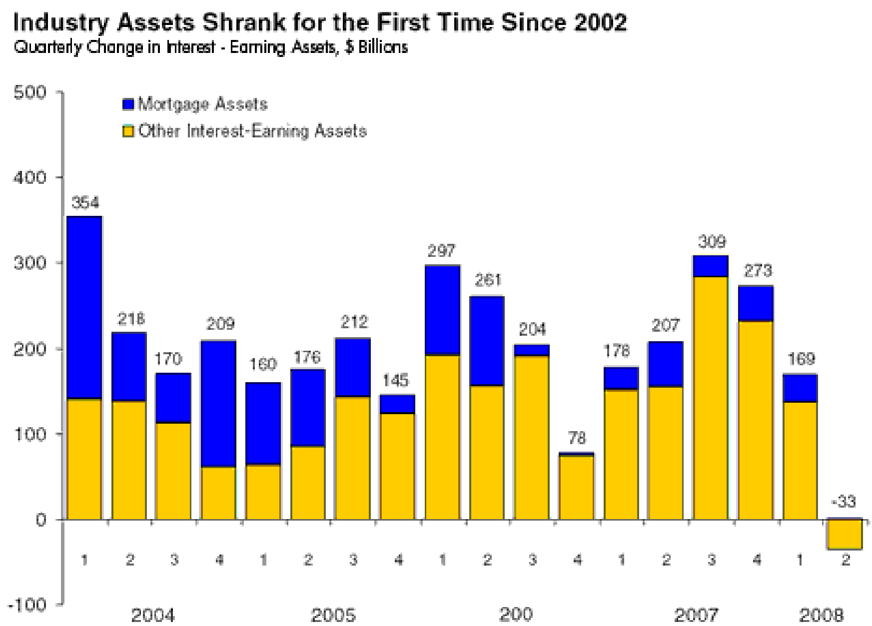
⇩ **Loan Charge-offs and Other Real Estate** - Loan losses registered a sizable jump in the second quarter, as loss rates on real estate loans increased sharply at many large lenders. Net charge-offs of loans and leases totaled $26.4 billion in the second quarter, almost triple the $8.9 billion that was charged off in the second quarter of 2007. The annualized net charge-off rate in the second quarter was 1.32 percent, compared to 0.49 percent a year earlier. This is the highest quarterly charge-off rate for the industry since the fourth quarter of 1991. At institutions with more than $1 billion in assets, the average charge-off rate in the second quarter was 1.46 percent, more than three times the 0.44 percent average for institutions with less than $1 billion in assets. Net charge-offs increased year-over-year for all major loan categories in the second quarter. Charge-offs of 1-4 family residential mortgage loans increased by $5.8 billion (821.9 percent), while charge-offs of real estate construction and land development loans rose by $3.2 billion (1,226.6 percent). Net charge-offs of home equity loans were $2.8 billion (632.7 percent) higher than a year earlier, charge-offs of loans to commercial and industrial (C&I) borrowers were up by $1.8 billion (127.5 percent), credit card charge-offs increased by $1.7 billion (47.4 percent), and charge-offs of other loans to individuals grew by $1.4 billion (70.3 percent).



⇳ **Capital -** The industry added $10.6 billion to its total regulatory capital in the second quarter, the smallest quarterly increase since the fourth quarter of 2003. A majority of institutions (60.0 percent) reported declines in their total risk-based capital ratios during the quarter. More than half (50.9 percent) of the 4,056 institutions that paid dividends in the second quarter of 2007 reported smaller dividend payments in the second quarter of 2008, including 673 institutions that paid no quarterly dividend. Dividend payments in the second quarter totaled $17.7 billion, less than half the $40.9 billion insured institutions paid a year earlier. Even with reduced dividend payments, fewer than half of all institutions (45.5 percent) reported higher levels of retained earnings compared to a year ago. Less than one-fourth of the $23.1 billion increase in industry loan-loss reserves in the second quarter was included in regulatory capital because the amount of reserves in regulatory capital cannot exceed 1.25 percent of an institution's total risk-weighted assets, and a number of institutions now have reserves that exceed that limit. Despite the slowdown in capital growth and the erosion in capital ratios at many institutions, 98.4 percent of all institutions (accounting for 99.4 percent of total industry assets) met or exceeded the highest regulatory capital requirements at the end of June.

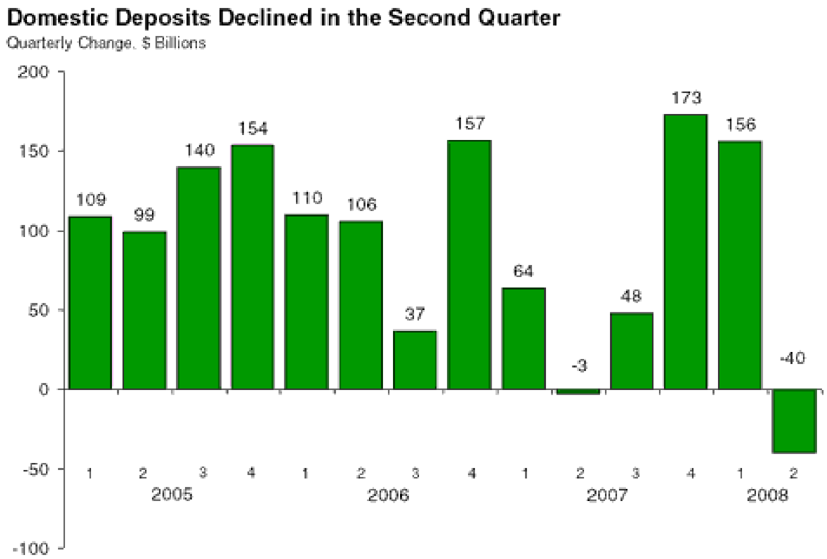
⇩ **Noncurrent Loan -** The amount of loans and leases that were noncurrent (90 days or more past due or in nonaccrual status) rose for a ninth consecutive quarter, increasing by $26.7 billion (19.6 percent). This is the second-largest quarterly increase in noncurrent loans during the nine-quarter streak, after the $27.0-billion increase in the fourth quarter of 2007 when quarterly net charge-offs were $10 billion lower. All major loan categories registered increased levels of noncurrent loans in the second quarter. The amount of 1-4 family residential real estate loans that were noncurrent increased by $11.7 billion (21.2 percent) during the quarter, while noncurrent real estate construction and land development loans rose by $8.2 billion (27.2 percent). Large increases were also reported in loans secured by nonfarm nonresidential real estate properties (up $2.0 billion, or 19.6 percent), C&I loans (up $1.8 billion, or 15.0 percent), and home equity loans (up $1.7 billion, or 25.5 percent). At the end of June, the percentage of the industry's total loans and leases that were noncurrent stood at 2.04 percent, the highest level since the third quarter of 1993. For the third consecutive quarter, insured institutions added almost twice as much in loan-loss provisions to their reserves for losses as they charged-off for bad loans. Provisions exceeded charge-offs by $23.8 billion in the second quarter, and industry reserves rose by $23.1 billion (19.1 percent). The industry's ratio of reserves to total loans and leases increased from 1.52 percent to 1.80 percent, its highest level since the middle of 1996. However, for the ninth consecutive quarter, increases in noncurrent loans surpassed growth in reserves, and the industry's "coverage ratio" fell very slightly, from 88.9 cents in reserves for every $1.00 in noncurrent loans, to 88.5 cents, a 15-year low for the ratio.

⇩ **Total Industry Assets -** Total assets of insured institutions declined by $68.6 billion during the quarter, the first time since the first quarter of 2002 that industry assets have decreased, and the largest quarterly decline since the first quarter of 1991. The reduction in assets was driven by a few large institutions, although almost 40 percent of all insured institutions reported lower assets at the end of June, compared to the end of March. Assets in trading accounts, which increased by $135.2 billion in the first quarter, declined by $118.9 billion (11.8 percent) in the second quarter. The industry's 1-4 family residential mortgage loans, which declined by $25.9 billion in the first quarter, fell by an additional $61.4 billion (2.8 percent) in the second quarter. Real estate construction and development loans registered their first quarterly decline since the first quarter of 1997, falling by $5.4 billion (0.9 percent). Total unused loan commitments declined by $145.9 billion (1.8 percent), while letters of credit increased by $28.9 billion (5.9 percent). Other real estate owned-properties acquired through foreclosure-increased by $3.5 billion (29.1 percent) during the quarter, to $15.6 billion at midyear.



⇧ **Small Business Loans -** The annual data on loans to small businesses and farms that are reported as of each June 30 showed that total small business and farm loans increased by $25.3 billion (3.4 percent) during the 12 months ended June 30. In contrast, larger loans to businesses and farms increased by $249.4 billion (18.4 percent) during that period. In the June 2006 to June 2007 period, small business and farm loans increased by $55.2 billion (7.9 percent). These loans currently account for almost one-third (32.7 percent) of all business and farm loans to domestic borrowers.

⇳ **Deposits -** Total deposits at insured institutions increased by only $6.9 billion (0.1 percent) in the second quarter, as the decline in industry assets reduced overall funding needs. Deposits in foreign offices increased by $46.8 billion (3.1 percent), while deposits in domestic offices fell by $39.8 billion (0.6 percent). In domestic offices, interest-sensitive deposits fell during the quarter, while interest-insensitive deposits grew. Domestic office time deposits declined by $50.6 billion (1.9 percent), while other domestic interest-bearing deposits fell by $19.6 billion (0.1 percent). Noninterest-bearing deposits in domestic offices rose by $30.4 billion (2.5 percent). Nondeposit liabilities declined by $66.1 billion (1.9 percent) during the quarter, due in large part to a $48.5-billion (11.9-percent) drop in liabilities in trading accounts.



⇧ **Bank Failures in the Second Quarter** - The number of institutions filing quarterly financial reports fell to 8,451 at the end of the second quarter, down from 8,494 at the end of the first quarter. Twenty-four new charters were added during the second quarter, while 64 existing charters were merged into other institutions. Two insured institutions failed during the quarter, bringing the total for the first six months of 2008 to four failures. Three mutually owned savings banks, with combined assets of $1.1 billion, converted to stock ownership in the second quarter. The number of institutions on the FDIC's "Problem List" increased from 90 to 117 during the quarter. Assets of "problem" institutions increased from $26.3 billion to $78.3 billion.

Bank and Thrift Closures Nationwide
Federal Deposit Insurance Corporation

Dates Covered: January 2004 to August 2008	Charter	Date Closed	Total Assets
Integrity Bank, Alpharetta, GA	State	08-29-2008	$1.1 Billion
The Columbian Bank and Trust, Topeka, KS	State	08-22-2008	$735 Million
First Priority Bank, Bradenton, FL	State	08-01-2008	$259 Million
First Heritage Bank, NA, Newport Beach, CA	National	07-25-2008	$255 Million
First National Bank of Nevada, Reno, NV	National	07-25-2008	$3.4 Billion
IndyMac Bank, F.S.B., Pasadena, CA	Federal Thrift	07-11-2008	$30.7 Billion
First Integrity Bank, NA, Staples, MN	National	05-30-2008	$52.9 Million
ANB Financial, NA, Bentonville, AR	National	05-09-2008	$1.8 Billion
Hume Bank, Hume, MO	State	03-07-2008	$18.6 Million
Douglass National Bank, Kansas City, MO	National	01-25-2008	$52.8 Million
Miami Valley Bank, Lakeview, Ohio	State	10-04-2007	$86.7 Million
NetBank, Alpharetta, Georgia	Federal Thrift	09-28-2007	$2.5 Billion
Metropolitan Savings, Pittsburgh, Pennsylvania	State	02-02-2007	$15.8 Million
Bank of Ephraim, Ephraim, Utah	State	06-25-2004	$46.4 Million
Reliance Bank, White Plains, New York	State	03-19-2004	$30.3 Million
Guaranty National Bank of Tallahassee, Tallahassee, Florida	National	03-12-2004	$74.1 Million
Dollar Savings Bank, Newark, New Jersey	National	02-14-2004	$12.3 Million

(Highlighted banks closed in 2008.)

Stock Performance
Southwest Regional Banks

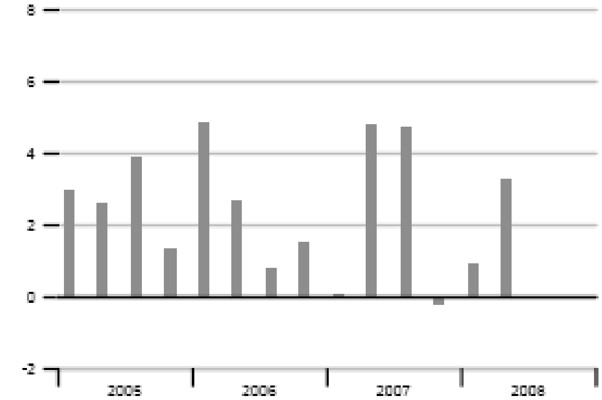
Name	Last Trade		52 Wk Range		PE	EPS	Mkt Cap	Div/Shr	Div Yld
Bancfirst Corporation	09/19	**73.10**	39.69	73.10	21.26	3.44	1.11B	0.80	1.10%
Banco Bilbao Vizcaya Argentaria	09/19	**16.81**	14.40	25.70	7.31	2.3	62.34B	0.86	5.10%
Bok Financial Corporation	09/19	**57.00**	38.21	61.41	22.37	2.55	3.84B	0.90	1.60%
Cass Information Sys Inc	09/19	**37.00**	25.01	40.55	19.32	1.92	338.40M	0.48	1.30%
Cobiz Incorporated	09/19	**13.57**	5.13	18.53	18.51	0.73	313.47M	0.28	2.10%
Comerica Inc.	09/19	**42.00**	19.31	55.02	13.69	3.07	6.32B	2.64	6.30%
Community Shores Bank Corp	09/19	**4.90**	3.01	10.68	N/A	-0.66	7.19M	N/A	N/A
Cullen Frost Bkrs Incorporated	09/19	**41.83**	28.50	41.83	N/A	N/A	N/A	N/A	N/A
Enterprise Fin Serv Corp	09/22	**21.05**	15.75	25.88	15.95	1.32	167.2M	0.21	0.91%
First Comnty Corp S C	05/05	**15.40**	N/A	N/A	N/A	N/A	N/A	N/A	N/A
First Federal Bankshares Inc	09/19	**5.09**	1.85	17.62	N/A	-6.92	16.82M	0.42	8.30%
First Financial Bankshares	09/19	**57.00**	34.49	67.00	22.98	2.48	1.19B	1.36	2.40%
First ST Bancorporation	09/22	**8.35**	3.90	21.00	N/A	-5.21	164.22M	0.36	4.20%
Firstcity Finl Corp	09/19	**4.89**	2.78	10.04	N/A	-0.83	50.11M	N/A	0.00%
Franklin Bank Corporation	09/22	**0.59**	0.62	0.58	2.19	0.27	14.97M	N/A	N/A
Great Southn Bancorp Inc	09/19	**13.41**	7.73	27.11	37.31	1.73	179M	N/A	3.90%
Guaranty Fed Bancshares Inc	09/19	**14.19**	12.15	30.50	36.12	0.393	38.33M	0.72	5.10%
Heartland Financial USA Inc	09/19	**24.48**	15.98	27.14	16.34	1.50	397.80M	0.40	1.60%
International Bancs Cor	09/22	**29.74**	18.25	35.80	15.20	1.96	2.04B	0.66	2.00%
Landmark Bancorp Inc	09/19	**20.00**	15.60	27.50	8.73	2.29	45.36M	0.76	3.80%
Liberty Bancorp Inc	09/19	**8.90**	4.50	11.00	19.78	0.45	35.10M	0.10	1.10%
Mackinac Finl Corp	09/17	**5.50**	5.05	9.70	1.80	3.06	18.80M	N/A	N/A
Metrocorp Bancshares Inc	09/19	**13.17**	9.85	17.10	13.75	0.96	143.03M	0.16	1.20%
Midwestone Finl Group Inc	09/19	**14.66**	11.94	19.24	11.12	1.32	126.90M	0.61	4.20%
Osage Bancshares Inc	09/19	**9.25**	7.47	10.38	27.13	0.34	30.09M	0.34	3.70%
Prosperity Bancs Inc	09/19	**39.00**	21.96	46.48	19.89	1.96	1.80B	0.50	1.30%
Qcr Holdings Inc	09/19	**14.65**	9.70	17.02	16.03	0.91	67.76M	0.08	0.50%
Sterling Bancshares Inc	09/19	**14.00**	6.80	14.01	20.62	0.68	1.02M	0.22	1.60%
Team Financial Inc	09/19	**3.29**	2.57	16.27	N/A	-3.30	11.83M	0.32	9.70%
Tex Capital Bancs Inc	09/22	**20.48**	13.51	22.94	20.20	1.02	548.900M	N/A	N/A
Tierone Corporation	09/19	**5.58**	2.48	28.17	N/A	-5.81	100.64M	0.16	2.90%
Umb Financial Corporation	09/19	**69.50**	34.95	69.60	31.04	2.24	2.84B	0.66	0.90%
West Bancorp Incorporated	09/19	**13.53**	7.30	16.21	15.62	0.87	235.46M	0.64	4.70%
Zions Bancorp	09/22	37.13	11.99	50.97	N/A	N/A	N/A	N/A	N/A

Source: Yahoo Finance (September 22, 2008)
NA – Indicates information was not available.

National Economic Trends

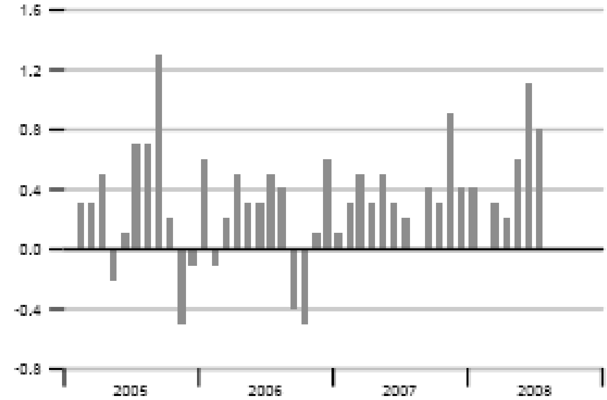
Real GDP Growth

Compounded annual rates of change



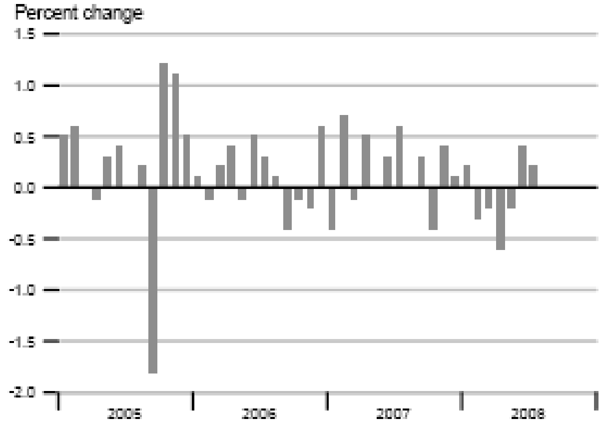
Consumer Price Index

Percent change



Industrial Production

Percent change

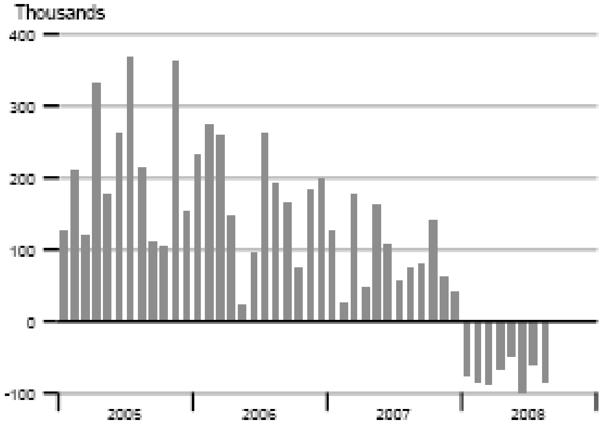


Interest Rates

Percent

Change in Nonfarm Payrolls

Thousands

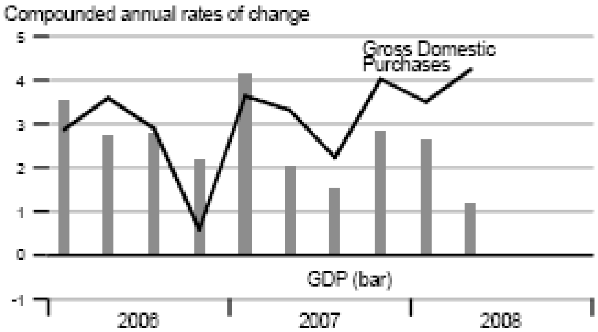


Unemployment Rate

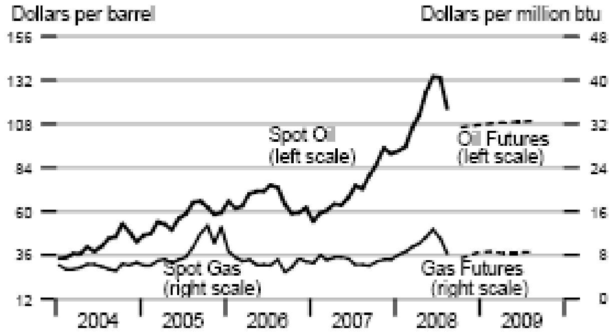
Percent of labor force

Provided by the Federal Reserve Bank of St. Louis, National Economic Trends. Updated September 8, 2008.

NIPA Chain Price Indexes

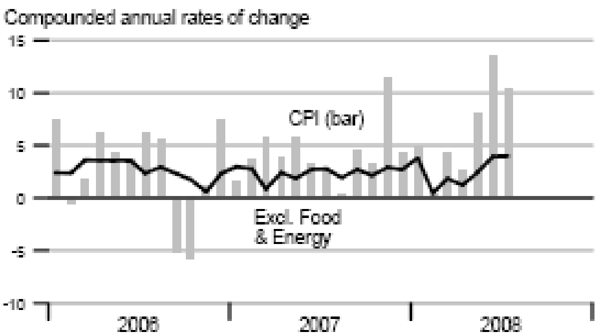


Oil & Natural Gas Prices: Spot & Futures

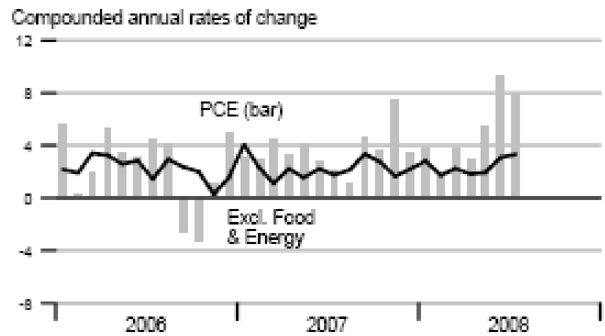


Note: Futures prices as of 09/05/2008.

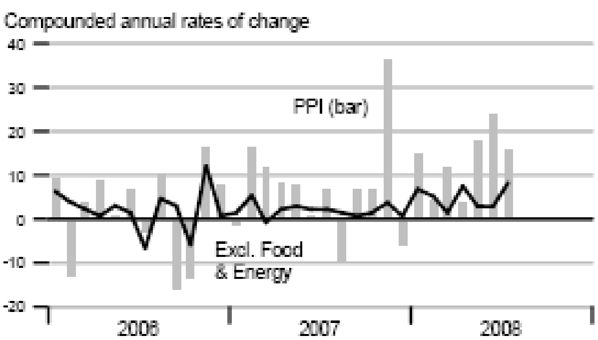
Consumer Price Index



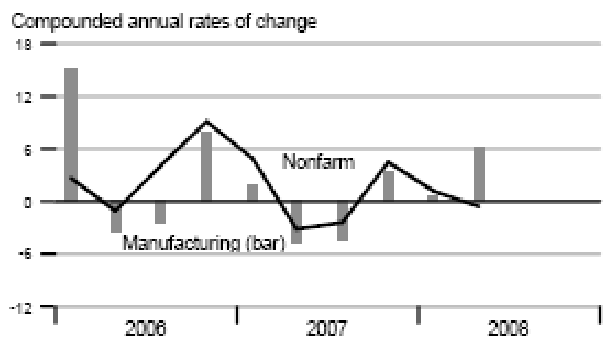
Consumption Chain Price Index



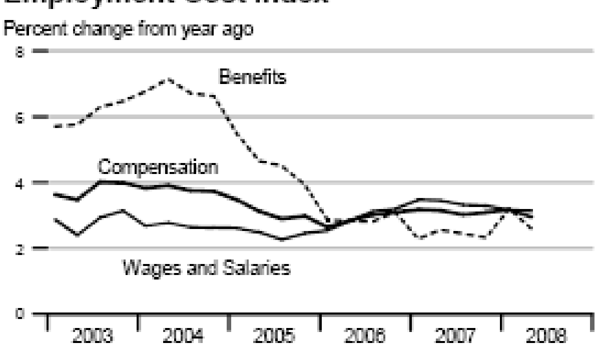
Producer Price Index, Finished Goods



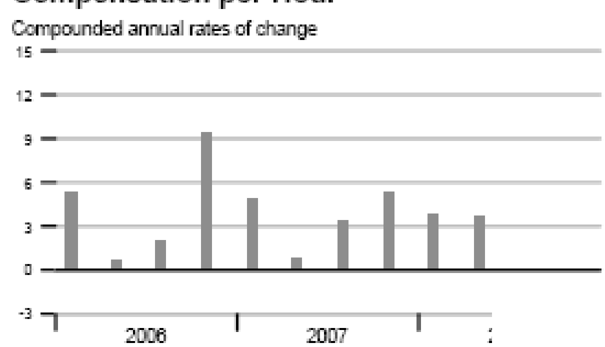
Unit Labor Cost



Employment Cost Index



Compensation per Hour



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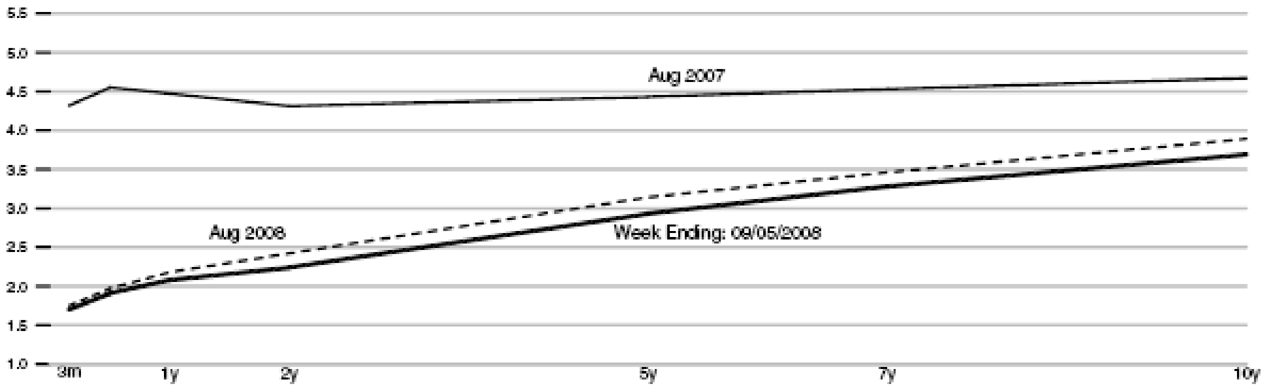
Interest Rates

Treasury Yield Curve



Standard and Poor's 500 Index with Reinvested Dividends

Provided by the Federal Reserve Bank of St. Louis, National Economic Trends. Updated September 8, 2008.

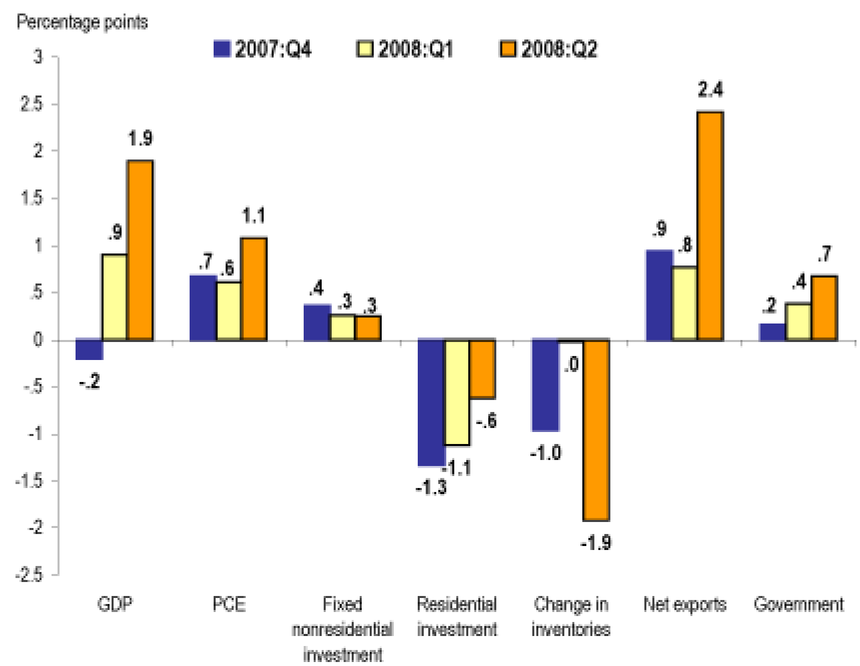
National Update – August 2008
Federal Reserve Bank of Dallas

⇳ **Overall Economy** - Economy Struggling but Still Expanding. Recent data point to a surprisingly resilient economy in spite of financial turmoil and troubles in the housing sector. Of growing concern, however, are increasingly significant upside risks to inflation and continued downside risks to growth.

⇧ **Gross Domestic Product** - Growth Picks Up in Second Quarter 2008. Growth in real gross domestic product (GDP) accelerated to a 1.9 percent annualized rate in second quarter 2008, largely due to growth in personal consumption expenditures (PCE) and net exports. The jump in net exports was a result of a sharp increase in exports (1.16 percentage points) and a sharp decrease in imports (1.26 percentage points). Inventory investment was the largest drag on second quarter growth, while the drag from residential investment was smaller than in the past few quarters. Although PCE growth for June was positive, growth in nominal personal consumption expenditures and income was more than offset by inflation.

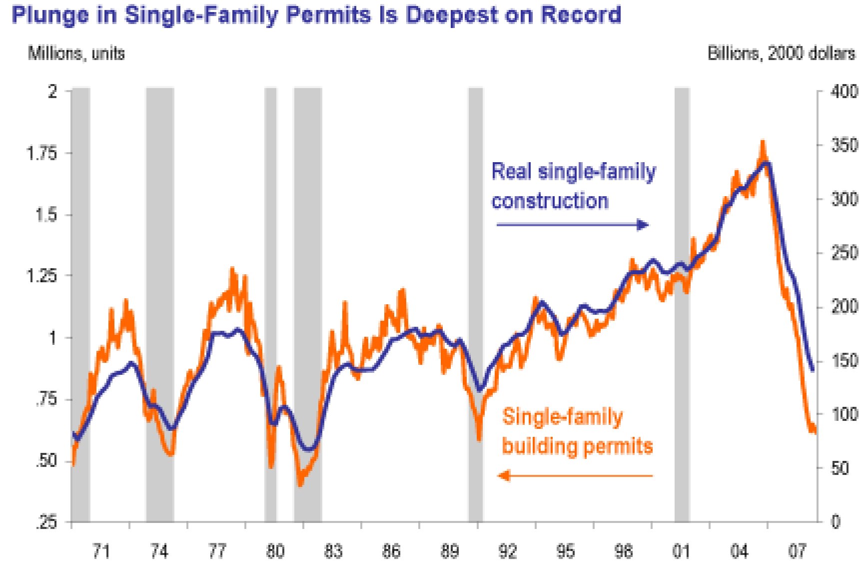
Durable-goods orders continued to be a bright spot, likely thanks to strong export demand. Excluding transportation, new orders for all manufactured goods increased 2.3 percent. According to the Institute for Supply Management (ISM) index, which measures the degree of expansions or contractions in the manufacturing industry, the manufacturing industry has continued to tread water, neither expanding nor contracting. Despite an uptick in the ISM nonmanufacturing index from 48.2 to 49.5, it still indicates contraction in the service sector, as it sits below 50.

Contributions to Recent Real GDP Growth



SOURCE: Bureau of Economic Analysis.

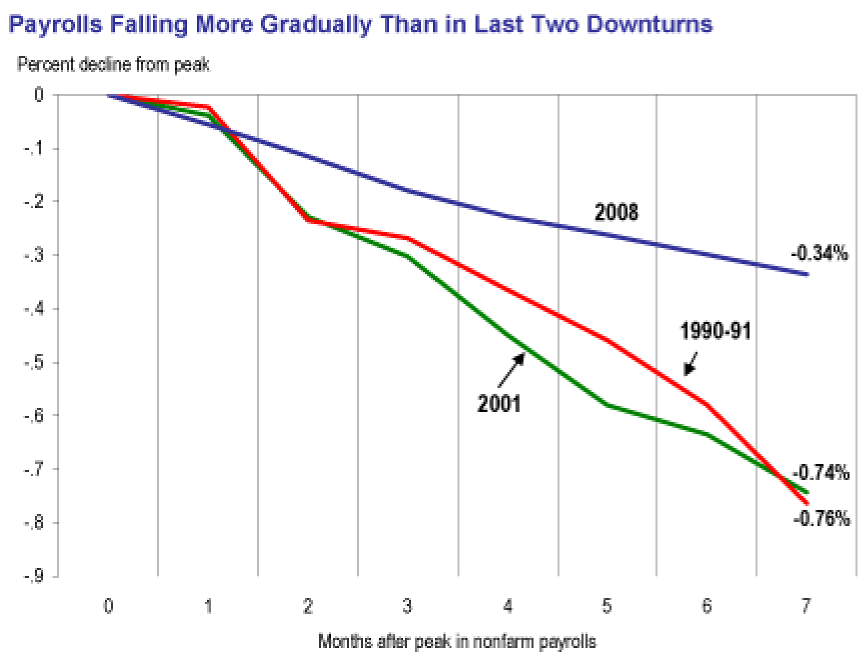
⇩ **Housing** – Housing Still Searching for Bottom. While the rate of decline in residential investment appears to be decelerating according to recent GDP numbers, the current downturn in single-family building permits—perhaps a timelier indicator of the housing market than quarterly GDP contributions—is the deepest since monthly records began in the early 1960s, having fallen 65.7 percent from their peak in September 2005. The 4.5 percent increase seen in April that followed 12 straight months of declines was unwound in May and June by 2.2 and 3 percent declines, respectively (Chart on next page). Both existing and new-home sales also continued down in June, suggesting that home sales have not yet hit bottom.



SOURCES: Bureau of Economic Analysis, Census Bureau.

⇩ **Employment** - Labor Markets Remain Soft. Labor markets have continued to soften. The unemployment rate increased 0.2 percentage points to 5.7 percent in July after being unchanged in June, following an increase of 0.5 percentage points to 5.5 percent in May. These increases reflect a particularly tough job market for teens as the unemployment rate for individuals 16–19 years old has risen by 3.2 percentage points since the start of the year. In contrast, that for individuals age 20 and older has only risen by 0.6 percentage points. Nonfarm payroll employment fell by 51,000 in July, following June and May figures that were revised to smaller declines of 51,000 and 47,000, respectively, showing a continued slow bleed of jobs.

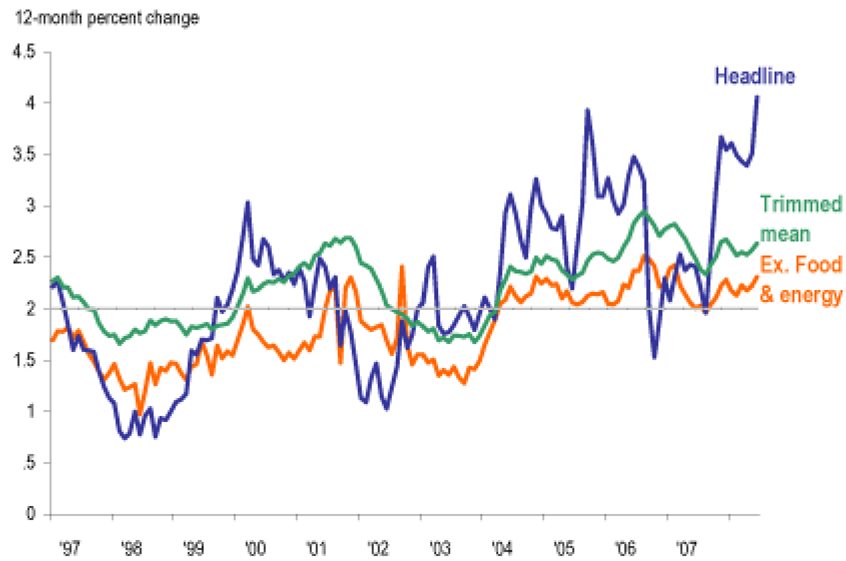
Since peaking in December last year, nonfarm payroll employment has fallen by 0.34 percent over the past seven months—about half the size of the declines seen in the first seven months after payroll employment peaked in both 1990 and 2001 (chart below). This suggests that job losses have not yet reached typical recessionary levels.



SOURCES: Bureau of Labor Statistics, Dallas Fed.

⇩ **Inflation** - Inflation rose notably in June. Core PCE inflation increased to a 3.2 percent annualized rate and is up 2.3 percent over the past 12 months. Slightly higher, trimmed mean PCE inflation increased to a 3.3 percent annualized rate and is up 2.6 percent from a year ago. Driven by large increases in energy and commodity prices, headline PCE inflation came in at a 9.5 percent annualized rate, the biggest one-month increase—excluding Hurricane Katrina—since 1981. Headline PCE inflation is up 4.1 percent from a year ago, a level approaching that of the '80s, if sustained. When considering some elevated indicators of both short- and long-term inflation expectations, such as the University of Michigan surveys, the inflation outlook is uncertain.

PCE Inflation Climbing



SOURCES: Bureau of Economic Analysis, Dallas Fed.

⇩ **Financial Markets Still Stressed** - Financial markets have remained under considerable stress. Mutual mistrust persists unabated in the interbank loan market and credit conditions are tight. Both junk and corporate investment-grade bond spreads widened in July, and friction continues to be felt in the interbank market. The TED spread, which is the three-month London Interbank Offered Rate less the three-month Treasury bill yield, widened some in July, apparently in reaction to the events surrounding Fannie Mae and Freddie Mac and the seizure of IndyMac by the FDIC.

Generational lows in consumer confidence and consumer sentiment have continued to drag down the stock market. Ongoing financial turmoil, weaker consumer spending and slowing growth abroad—which may weaken the one strong leg on which the economy currently stands—all suggest that real growth may slow over the coming quarters.

Economic Statistics
U. S. Bureau of Labor Statistics

Data Series	March 2008	April 2008	May 2008	June 2008	July 2008	Aug 2008
Unemployment Rate [(1)]	5.1	5.0	5.5	5.5	5.7	6.1
Change in Payroll Employment [(2)]	-88	-67	-47	-100	-60 [(P)]	-84 [(P)]
Average Hourly Earnings [(3)]	17.87	17.89	17.95	18.00 [(P)]	18.07 [(P)]	18.14 [(P)]
Consumer Price Index [(4)]	0.3	0.2	0.6	1.1	0.8	-0.1
Producer Price Index [(5)]	0.9	0.3	1.4 [(P)]	1.8 [(P)]	1.2 [(P)]	-0.9 [(P)]
U.S. Import Price Index [(6)]	3.1	2.8 [(9)]	2.8 [(9)]	3.1 [(9)]	0.2 [(9)]	-3.7 [(9)]
Employment Cost Index [(7)] [(10)]	0.7	0.7				
Productivity [(8)]	2.6	4.3				

Footnotes:
[(P)] Preliminary
[(1)] In percent, seasonally adjusted.
[(2)] Number of jobs, in thousands, seasonally adjusted
[(3)] For production and nonsupervisory workers on private nonfarm payrolls, seasonally adjusted
[(4)] All items, U.S. city average, all urban consumers, 1982-84=100, 1-month percent change, seasonally adjusted
[(5)] Finished goods, 1982=100, 1-month percent change, seasonally adjusted
[(6)] All imports, 1-month percent change, not seasonally adjusted
[(7)] Compensation, all civilian workers, quarterly data, 3-month percent change, seasonally adjusted
[(8)] Output per hour, nonfarm business, quarterly data, percent change from previous quarter at annual rate, seasonally adjusted
[(9)] Revised
[(10)] Includes wages, salaries, and employer costs for employee benefits.

Data extracted on: September 24, 2008

The Beige Book – September 3, 2008
The Federal Reserve Board

Economy – Reports from the twelve Federal Reserve Districts indicate that the pace of economic activity has been slow in most Districts. Many described business conditions as "weak," "soft," or "subdued." Cleveland and St. Louis reported some weakening since their last reports while Boston and New York noted signs of stabilization. Kansas City reported a slight improvement.

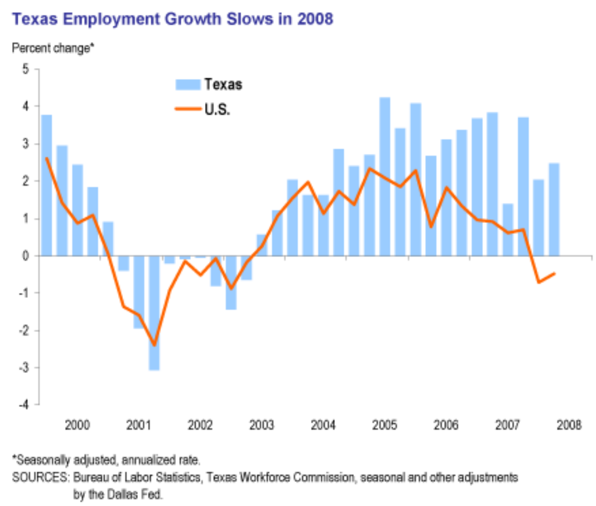
Consumer spending was reported to be slow in most Districts, with purchasing concentrated on necessary items and retrenchment in discretionary spending. Districts reporting on auto sales described them as falling or steady at low levels. Tourism activity was mixed but received support from international visitors in several Districts, and the demand for services eased in most Districts. The transportation industry was also adversely affected by rising fuel costs. Manufacturing activity declined in most Districts but improved somewhat in Minneapolis and Kansas City. Most Districts reported that residential real estate markets remained soft. Commercial real estate activity was slow in most Districts, and some reported further slackening in demand for office and retail space. Most Districts reported easing loan demand, especially for residential mortgages and consumer loans; lending to businesses was mixed. Districts reporting on the agricultural sector noted some relief from drought conditions. Districts reporting on energy and mining activity recorded increased activity.

Almost all Districts continued to report price pressures from elevated costs of energy, food, and other commodities, although some noted that there have been declines or slower increases in prices for several industrial commodities and energy products. Business contacts in a number of Districts indicated that they had increased selling prices in response to the high costs for their inputs. Wage pressures were characterized as moderate by most Districts amid a general pullback in hiring, although several Districts noted continued strong demand for workers in the energy sector.

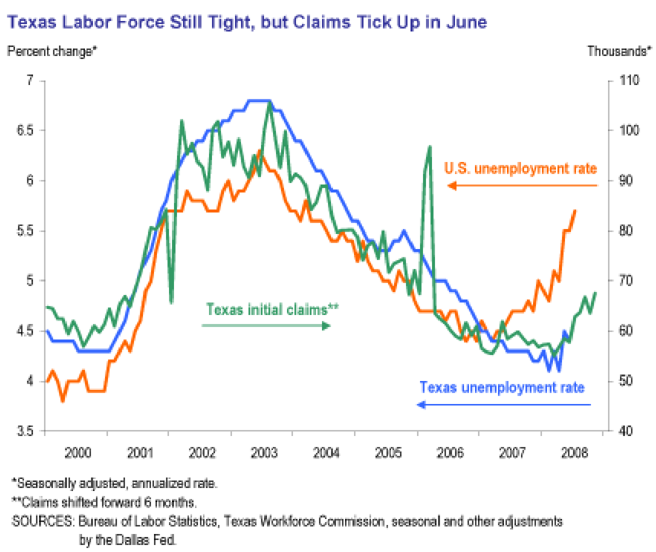
Regional Economic Update – August 2008
Federal Reserve Bank, Dallas

⇧ **Overall Economy** - The regional economy is expanding at a moderate pace and continues to outperform the national average. Certain sectors of the Texas economy are showing signs of weakness, yet the overall effects have been mitigated by strength in exports and the energy sector.

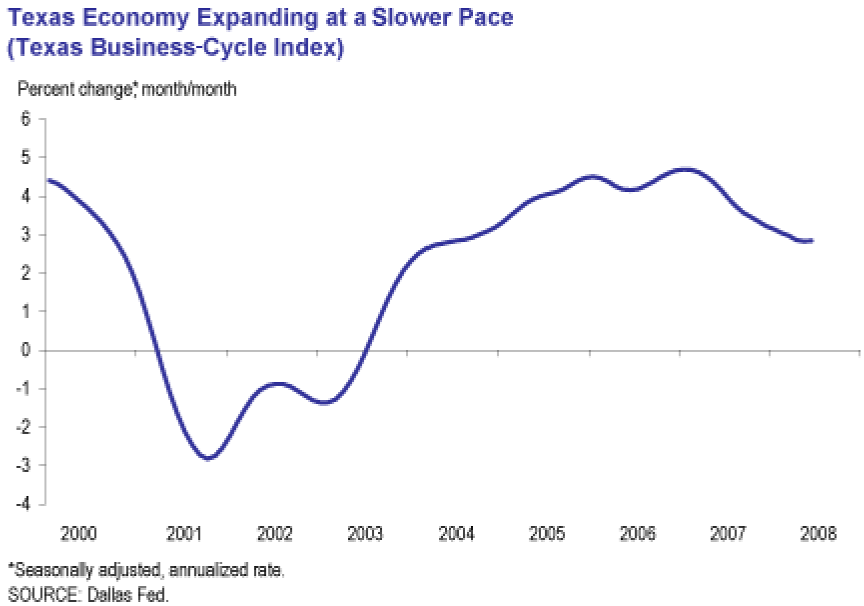
⇳ **Employment -** Texas employment grew at an annualized rate of 2.3 percent in the first half of this year, below the 3.2 percent pace recorded in 2007. Comparatively, U.S. employment fell 0.6 percent in the first half of 2008.



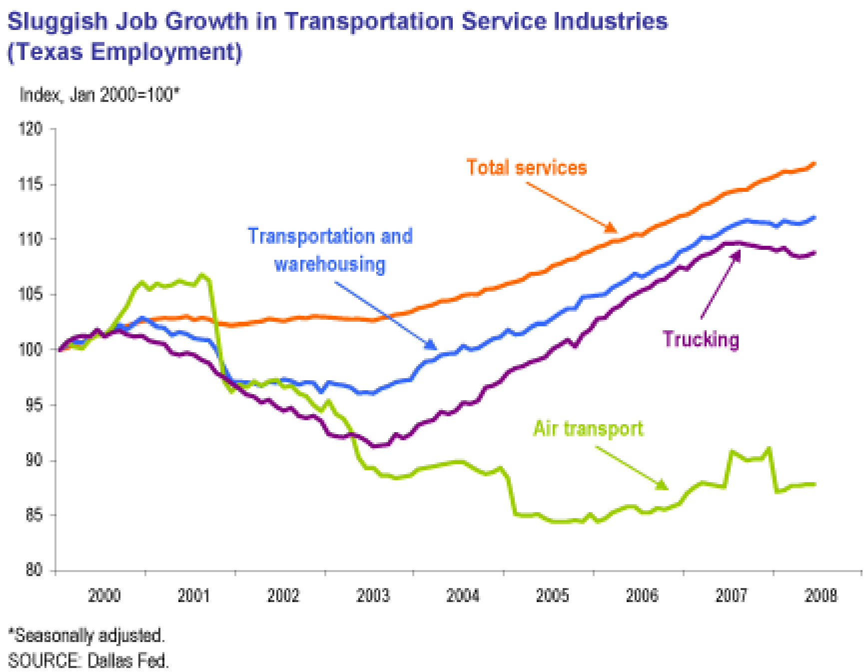
Texas initial claims for unemployment insurance increased 6.2 percent in June and have risen almost 16 percent since the first of the year. The Texas unemployment rate currently remains near historic lows, but the uptick in claims suggests some future slack in the labor market consistent with recent layoff announcements in some sectors. The minimum wage rose from $5.85 to $6.55 on July 24—the impact will likely be limited to certain lower-wage sectors of the economy



⇩ **Business Cycle Index -** The Texas Business-Cycle Index, a gauge of current business activity, suggests the economy is currently growing at a slower pace than in recent years. Growth in the index began decelerating in the latter half of 2007 and has continued into 2008. The general slowdown in regional economic growth has been echoed in anecdotal reports such as the Dallas Beige Book.

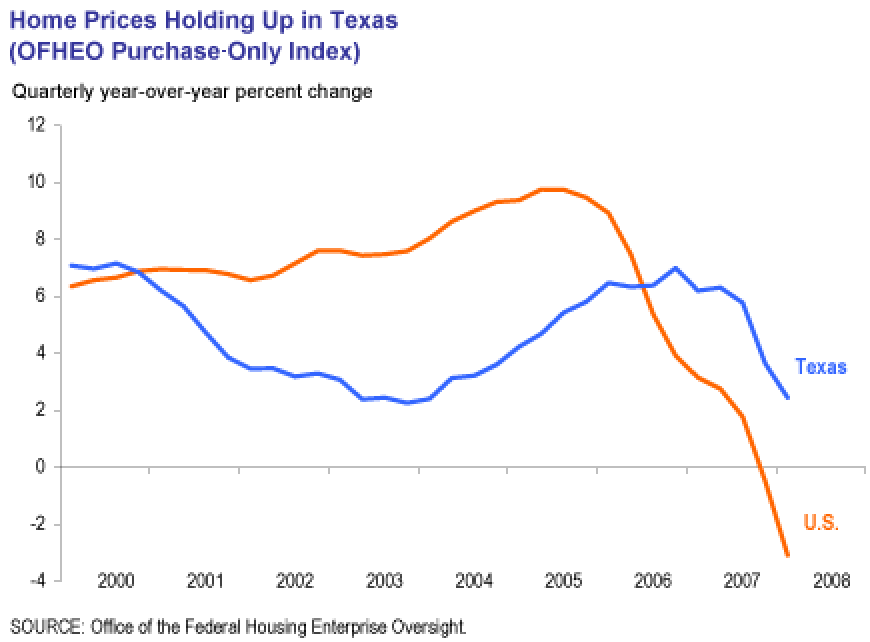


⇩ **Transportation Sector** – Elevated fuel costs strained transportation-related industries in the second quarter. Most noticeably impacted were airlines and trucking firms, and employment levels are beginning to reflect the weakness. Airlines rapidly implemented baggage surcharges and increased fares in an effort to combat rising energy costs, while the trucking industry has steadily raised fuel surcharges to offset the surge in diesel prices.



⇳ **Real Estate Activity** – Texas housing markets saw further deterioration in sales and construction in the second quarter. According to the Dallas Beige Book, homebuilders said sales weakened in June causing outlooks to be more guarded.

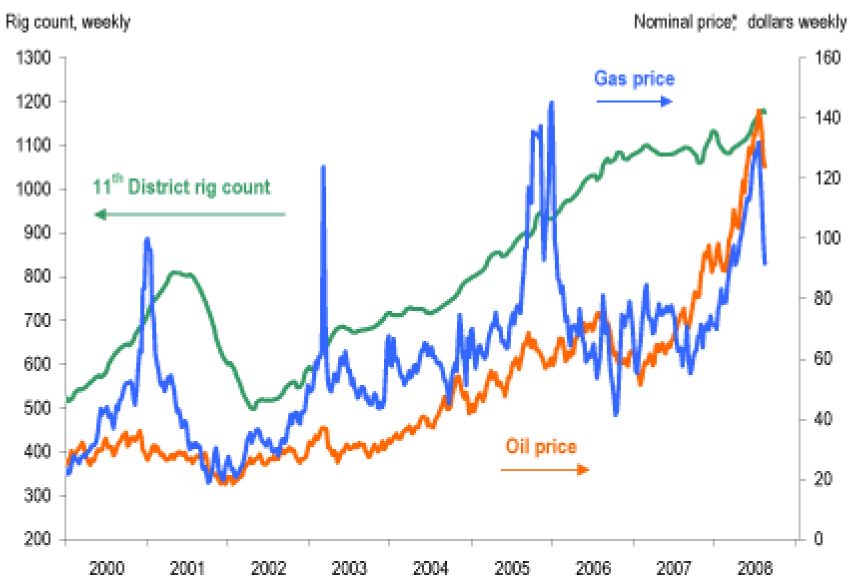
On a brighter note, the Texas housing market is better off than many other parts of the country in some aspects. Home prices are holding up better in Texas. The Office of Federal Housing Enterprise Oversight (OFHEO) purchase-only home price index showed modestly positive appreciation of 2.5 percent in Texas during the first quarter, compared with a decline of 3.1 percent nationally. In addition, Texas home inventories remain near equilibrium levels, and the foreclosure rate in Texas is below the national average.



⇩ **Commercial Real Estate** – The current credit situation, most notably the dropoff in demand for commercial mortgage-backed securities, has had a large impact on commercial real estate investment activity, both nationally and in Texas. According to anecdotal reports, investors are increasingly concerned about the supply of credit as lenders shy away from real estate. In addition, the backlog of nonresidential development projects continues to dwindle, and there are reports that new deal volume is sluggish. Nonresidential construction is expected to slow in the second half of the year.

⇧ **Energy and Business Services** - While high energy prices are negatively impacting consumers and some businesses, overall they are boosting growth in the Texas economy. The rig count rose in the second quarter as both oil and natural gas drilling increased. Drilling companies are hiring and demand is high for professionals in service industries related to energy. Texas exports have grown faster than the national average this year. Manufacturing respondents to the Dallas Fed's July Texas Manufacturing Outlook Survey noted exports are helping shore up demand for products despite domestic weakness.

Drilling Activity on the Rise



*Gas price is multiplied by 10
SOURCES: *Wall Street Journal*, Dallas Fed, seasonal and other adjustments by the Dallas Fed.

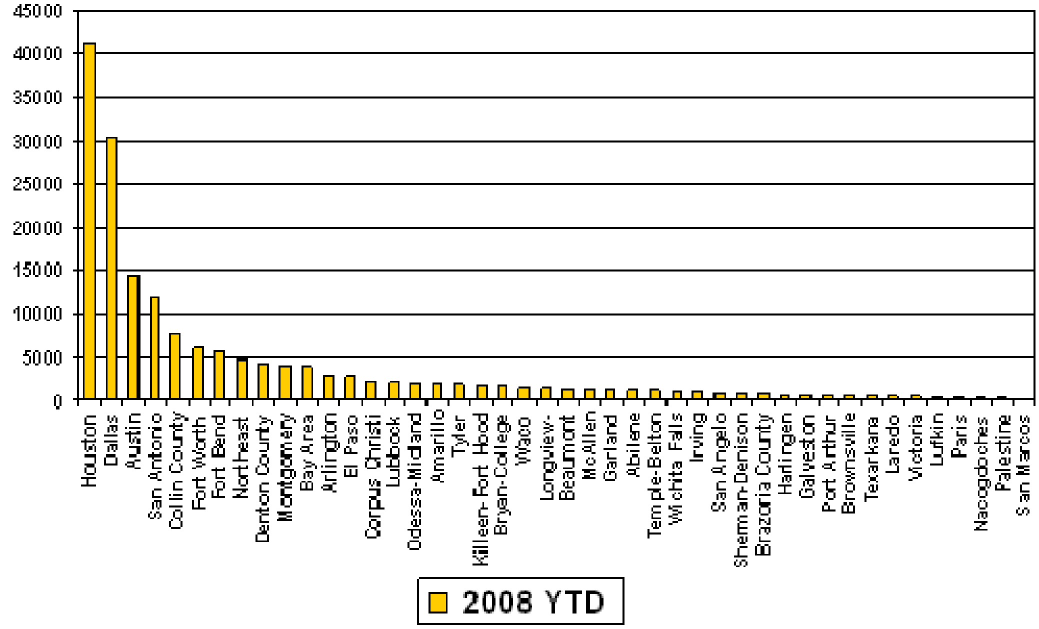
⇩ **Outlook** - Economic headwinds—including uncertainty about the pace of recovery in credit markets, continued weakness in housing and the impact of higher transportation costs on businesses and consumers—will create a challenging environment. According to the Dallas Fed's Texas Leading Index, the outlook continues to suggest below-trend employment growth in the second half of the year.

Data Series	Feb 2008	Mar 2008	Apr 2008	May 2008	Jun 2008	Jul 2008[(P)]
Civilian Labor Force [(1)]	**11,561.9**	**11,632.8**	**11,675.9**	**11,712.2**	**11,682.4**	**11,691.7**
Unemployment Rate [(2)]	**4.1**	**4.3**	**4.1**	**4.5**	**4.4**	**4.7**
Total Nonfarm [(3)]	10,501.6.6	10,539.4	10,561.6	10,566.9	10,612.0	10,629.7
Natural Resources and Mining [(3)]	2.3	2.3	2.6	2.3	2.3	2.4
Construction [(3)]	651.9	655.2	662.1	663.5	668.9	672.2
Manufacturing [(3)]	932.6	932.0	930.4	929.9	928.9	926.6
Trade, Transportation, and Utilities [(3)]	2,128.9	2,142.6	2,139.6	2,140.1	2,145.6	2,145.8
Financial Activities [(3)]	646.1	647.1	651.3	650.8	653.0	653.8
Professional & Business Services [(3)]	1,329.7	1,335.7	1,344.5	1,345.5	1,357.1	1,356.1
Educational & Health Services [(3)]	1,278.4	1,283.2	1,283.9	1,286.9	1,294.8	1,293.9
Leisure & Hospitality [(3)]	1,004.7	1,010.3	1,013.6	1,014.6	1,017.8	1,021.2
Government [(3)]	1,734.8	1,740.0	1,741.1	1,741.1	1,748.2	1,761.2
Layoff events, all industries	47	36	48	55	60	43

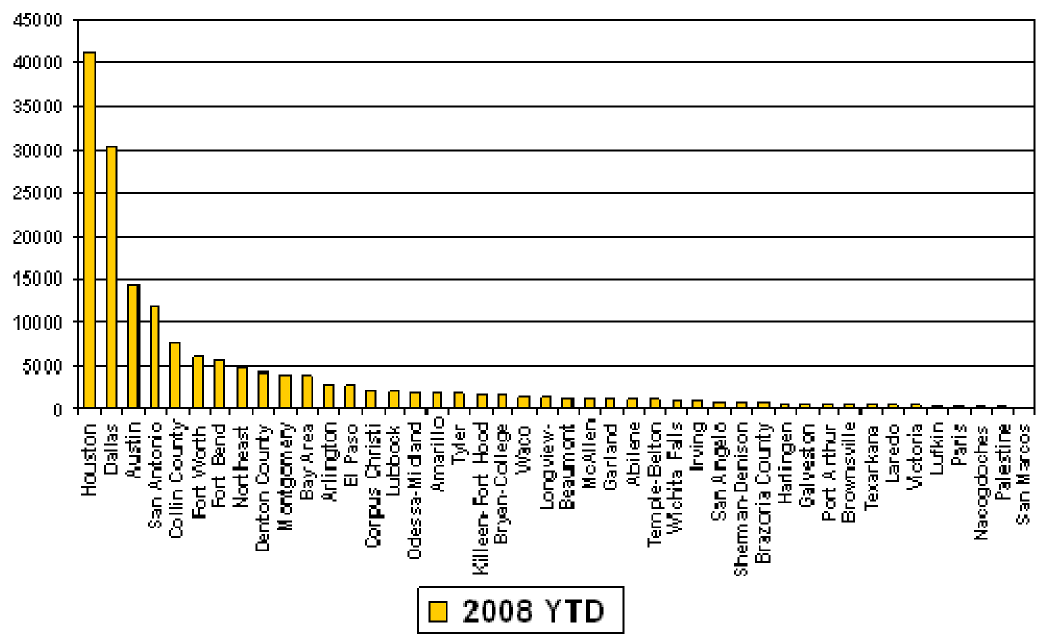
Footnotes:
(1) Number of persons, in thousands, seasonally adjusted.
(2) Percent.
(3) Number of jobs, in thousands, seasonally adjusted.
(P) Preliminary

Data extracted on: September 16, 2008
Source: U. S. Bureau of Labor Statistics

Texas Residential MLS Activity
Number of Houses for Sale



Texas Residential MLS Activity
Number of Homes Sold



TEXAS BANKER AND BUSINESS ECONOMIC SURVEY

- **Survey of Banking and the Economy** – The Banker and Business Economic Survey is conducted monthly by the Texas Department of Banking and reflects the opinions of executives of state-chartered banks throughout Texas. The banker selection varies but is intended to provide a good cross-section of state-chartered banks in Texas, both in size and location. Bankers who are asked to participate in the survey are selected from rural and metropolitan markets alike, and each state-chartered bank is sent a survey once each year. The second quarter 2008 survey includes responses from 60 bankers.

  - **Local Economy** – Bankers continue to be upbeat about economic conditions in Texas, though some erosion of their confidence is evident. A smaller percentage of bankers believe that economic conditions are improving; while a greater percentage (68%) believe that economic conditions are about the same. On the positive side, fewer bankers (5%) report that economic conditions are deteriorating. Responses continue to reflect concern for a softening in the residential real estate markets. Conditions in the commercial real estate markets are more positive than in the residential markets. Statewide employment continues to improve: 35% of the respondents reported increasing employment; 63% reported conditions about the same; and only 2% reported deteriorating employment conditions.

  - **Economic Indicator Forecasts –** Respondents continue to indicate that oil and gas production are having an overall positive influence on their local economy. A much higher percentage of bankers (40%) expect declining interest rates over the next six months than the percentage that expect increasing rates (13%). The largest percentage of bankers (47%), however, expects interest rates to remain about the same. 87% of the bankers surveyed believe that fuel prices will increase over the next six months, while only 5% believe that prices will remain about the same, and only 8% believe they will decrease.

  - **Competition –** Bankers indicate that competition remains strong.

Rated Area	*Significantly Increasing*	*Increasing*	*About the Same or Decreasing*
Consumer Loans	5%	30%	60%
Commercial Loans	7%	45%	49%
Deposits	8%	55%	37%

  - **Bank Growth Characteristics from the Fourth Quarter 2007 as compared to the First Quarter 2008 –** Overall, bankers report satisfactory growth with 51% indicating an increase in total assets and 42% remaining the same. Loan growth also appears healthy with 52% reporting an increase.

  - **Earnings – Second Quarter Versus First Quarter 2008 –** A significant change in earnings projections is noted from the previous survey. A much greater percentage of respondents (33% versus 16%) expect deteriorating performance. As expected, market interest rates reductions are having a detrimental effect on community banks' net interest margins, and the survey results reflect this pressure: 41% of the respondents report a decreasing net interest margin, 38% about the same, while 20% report a higher margin.

  - **Asset Quality Indicators -** Asset quality indicators are mixed. On average, more bankers experienced increases in past due and nonaccrual loans, but a greater number of respondents reported decreases in repossessed assets and customer bankruptcies. Concerns about credit quality appear to be affecting loan underwriting standards as more than half (56%) of the respondents indicate they are tightening loan underwriting standards.

  - **Summary –** Most bankers report that their local economy is strong, and their bank is well positioned to take advantage of these positive economic times. However, these concerns were replaced with apprehension about decreasing interest rates and the effects that these rate changes will pose to net interest margins.

  - **Bankers Note That –** A positive economic climate is expected, and many of the respondents believe their institutions are positioned to take advantage of this positive climate. Fewer bankers in this survey expressed concern about competition and regulatory burden than in previous surveys and instead focused on changes in interest rates and oil and gas activity.

❖ **Senior Loan Officer Opinion Survey** - The Federal Reserve's July 2008 survey of lending practices addresses changes in the supply of, and demand for, bank loans to businesses and households over the past three months.

- **Lending to Businesses** – Domestic and foreign institutions reported having tightened their lending standards and terms for a broad range of loan types over the past three months. Demand for bank loans reportedly had weakened, on net, for both businesses and households over the same period.

- **Commercial and Industrial Loan Demand** – About 60 percent of domestic banks—a slightly larger fraction than in the April survey—reported having tightened lending standards on commercial and industrial (C&I) loans to large and middle-market firms over the past three months. About 65 percent of those institutions—up notably from roughly 50 percent in the April survey—also indicated that they had tightened their lending standards on C&I loans to small firms over the same period.

  Significant majorities of domestic respondents indicated that they had tightened selected price terms on C&I loans to firms of all sizes: About 80 percent of banks—up from roughly 70 percent in the April survey—noted that they had increased spreads of loan rates over their cost of funds on C&I loans to large and middle-market firms, and about 70 percent of respondents—a somewhat higher fraction than in the April survey—reported having widened spreads on loans to small firms. In addition, considerable fractions of domestic respondents reported having boosted non-price-related lending terms on C&I loans to firms of all sizes over the survey period, and the fraction of banks that tightened such terms on loans to small firms increased significantly relative to the April survey.

  About 35 percent of U.S. branches and agencies of foreign banks—down from about 60 percent in the April survey—indicated that they had tightened their lending standards on C&I loans over the past three months. Majorities of foreign respondents reported that they had tightened various price terms on such loans, although the fractions of those institutions that reported having tightened such terms over the previous three months were, on net, significantly smaller than in the April survey. For example, about 60 percent of foreign banks—down from about 80 percent in the April survey—reported having raised spreads of loan rates over their cost of funds over the past three months.

  Very large majorities of domestic and foreign respondents pointed to a less favorable or more uncertain economic outlook, their bank's reduced tolerance for risk, and the worsening of industry-specific problems as reasons for tightening their lending standards and terms on C&I loans over the past three months. Roughly 65 percent of foreign respondents—up from about 45 percent in the April survey—also noted that concerns about their bank's current or expected capital position had contributed to the morestringent lending policies over the past three months. In contrast, only about 25 percent of domestic respondents—down from about 35 percent in the April survey—reported having tightened their lending standards because of concerns about their bank's current or expected capital position. On balance, the July survey pointed to a further weakening of C&I loan demand over the past three months. On net, about 15 percent of small domestic and 25 percent of foreign banks reported weaker demand for C&I loans from firms of all sizes over the survey period. About 15 percent of large domestic banks, on net, experienced weaker demand from small firms, although about 5 percent of these banks, on balance, reported that demand for C&I loans from large and middle-market firms had increased over the past three months.

  Substantial majorities of domestic institutions that experienced weaker loan demand over the past three months cited a decrease in customers' needs to finance investment in plant or equipment as well as firms' decreased need to finance inventories. In addition, about 65 percent of domestic and 70 percent of foreign respondents pointed to a decrease in customers' needs for merger and acquisition financing as a reason for the lower demand for C&I loans. Regarding future business, small domestic and foreign institutions, on balance, reported that inquiries from potential business borrowers were about unchanged during the survey period. In contrast, about 15 percent of large domestic banks, on net, reported an increase in the number of inquiries from potential business borrowers over the past three months.

- **Commercial Real Estate** – About 80 percent of domestic banks—a fraction similar to that in the April survey—reported having tightened their lending standards on commercial real estate loans over the past three months. About 35 percent of foreign banks—down from roughly 55 percent in the April survey—also indicated that they had tightened their lending standards on commercial real estate loans. Regarding demand for these types of loans, about 30 percent of domestic banks and 45 percent of foreign institutions—fractions somewhat smaller than those in the April survey—reported weaker demand for commercial real estate loans over the survey period on net.

- **Lending to Households** – Large majorities of domestic respondents reported having tightened their lending standards on prime, nontraditional, and subprime residential mortgages over the previous three months. About 75 percent of domestic respondents—up from about 60 percent in the previous survey—indicated that they had tightened their lending standards on prime mortgages. Of the 32 respondents that originated nontraditional residential mortgage loans, about 85 percent—up from about 75 percent in the April survey—reported having tightened their lending standards on such loans. Finally, 6 of the 7 respondents that originated subprime mortgage loans—a somewhat higher proportion than in the April survey—indicated that they had tightened their lending standards on those loans over the past three months. On net, about 30 percent of domestic respondents—a slightly higher fraction than in the April survey—experienced weaker demand for prime residential mortgage loans over the past three months, and about 45 percent—up from roughly 30 percent in the April survey—saw weaker demand for nontraditional mortgage loans over the same period. On balance, 2 of the 7 domestic banks that originated subprime mortgage loans reported weaker demand for subprime loans over the survey period—a proportion significantly smaller than in the April survey. About 80 percent of domestic respondents—up from about 70 percent in the April survey—noted that they had tightened their lending standards for approving applications for revolving home equity lines of credit (HELOCs) over the past three months. Concerning demand for this product, about 10 percent of domestic banks, on net, reported weaker demand for HELOCs over the past three months, down from about 20 percent in the April survey.

- **Securitizations and Sales of Conforming-Jumbo Mortgage Loans** – About 30 percent of domestic respondents indicated that their bank had securitized with, or sold to, Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) conforming-jumbo mortgage loans over the past three months, and about 45 percent of respondents expected their bank to do so over the next six months. As reasons for not securitizing or selling conforming-jumbo loans over the past three months or in the next six months, about 50 percent of respondents pointed to a lack of demand for conforming-jumbo loans at their bank, and about 45 percent cited the cost of the GSEs' guarantee fees or other pricing terms. Finally, roughly 40 percent of respondents pointed to a limited number of mortgage applicants at their bank who meet the GSEs' underwriting criteria.

- **Consumer Lending** – About 65 percent of domestic banks—up notably from about 30 percent in the April survey—indicated that they had tightened their lending standards on credit card loans over the past three months, and about the same fraction of respondents—up from roughly 45 percent in the April survey—reported having tightened standards on consumer loans other than credit card loans. In addition, considerable fractions of respondents reported having increased minimum required credit scores on both types of consumer loans and reduced the extent to which such loans were granted to customers who did not meet their bank's credit-scoring thresholds. Finally, large net fractions of banks noted that they had lowered credit limits on credit card accounts over the past three months, and increased interest rate spreads on consumer loans other than credit card loans. On balance, about 35 percent of domestic banks—up from roughly 25 percent in the April survey—expressed a diminished willingness to make consumer installment loans relative to three months earlier. Regarding loan demand, about 30 percent of respondents, on net, indicated that they had experienced weaker demand for consumer loans of all types over the past three months, up from about 20 percent in the April survey.

Deposit Growth

Deposit Growth at 10 Large Texas Banks and Thrifts			
Data as of June 3, 2008. Dollars in millions*			
Company name	City	2008 2Q total deposits	From Last Quarter deposit growth rate
Comerica Bank	Dallas	42,694	-9.60
Frost National Bank	San Antonio	10,758	-0.62
Amegy Bank National Association	Houston	8,745	3.65
International Bank of Commerce	Laredo	6,061	-0.7
Prosperity Bank	El Campo	5,320	6.42
Sterling Bank	Houston	3,702	1.36
First National Bank	Edinburg	3,639	6.25
Bank of Texas NA	Dallas	3,518	2.14
PlainsCapital Bank	Lubbock	2,508	1.23
Woodforest National Bank	Houston	2,424	3.64

* Listed in order of total assets size.

National Events

National

- **<u>September 19, 2008</u>** – The U.S. Treasury Department announced the establishment of a temporary guaranty program for the U.S. money market mutual fund industry. For the next year, the U.S. Treasury will insure the holdings of any publicly offered eligible money market mutual fund – both retail and institutional – that pays a fee to participate in the program. (*U.S. Department of the Treasury)*

- **<u>September 19, 2008</u> -** President Bush outlines five measures to address the nation's financial challenges.

  1. The Administration will work with Congress to pass legislation approving the Federal government's purchase of difficult–to-sell assets, such as troubled mortgages, from banks and other financial institutions.
  2. The Treasury Department is acting to restore confidence in a key element of America's financial system – money market mutual funds.
  3. The Federal Reserve is also taking steps to provide additional liquidity to money market mutual funds, which will help ease pressure on our financial markets.
  4. The Securities and Exchange Commission has issued new rules temporarily suspending the practice of short selling on the stocks of financial institutions.
  5. The Administration looks forward to working with Congress on measures to bring greater long-term transparency and reliability to the financial system.

  (*The White House)*

Acknowledgements

Information used throughout this report originated from the following sources:

- Administrative Office of the U.S. Courts
- American Banker, American Banker
- Business Roundtable, Washington, D.C.
- The Consumer Confidence Board, New York, NY
- Federal Deposit Insurance Corporation, Washington, D.C.
- Federal Reserve Bank of Dallas, Dallas, TX
- Federal Reserve Bank of St. Louis, St. Louis, MO
- Federal Reserve Board, Washington D.C.
- Real Estate Center, Texas A&M University, College Station, TX
- RealtyTrac, Inc., Irvine, CA
- Texas Department of Banking, Austin, TX
- Texas Department of Savings and Mortgage Lending, Austin, TX
- Texas Workforce Commission, Austin, TX
- The White House, Washington D.C.
- U.S. Bureau of Labor Statistics, Washington, D.C.
- U.S. Department of Commerce, Washington, D.C.
- U.S. Department of Housing and Urban Development, Washington, D.C.
- U.S. Department of the Treasury
- Yahoo Finance