

Guaranty Financial Group Inc.
Form 10-Q
August 11, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2008

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period From _____ to _____

Commission File Number: 001-33661

Guaranty Financial Group Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

74-2421034

(I.R.S. Employer Identification Number)

1300 MoPac Expressway South, Austin, Texas 78746

(Address of Principal Executive Offices, including Zip code)

(512) 434-1000

(Registrant's telephone number, including area code)

Not Applicable

(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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

| Class | Number of common shares outstanding as of June 30, 2008 |
|---|--|
| Common Stock (par value \$1.00 per share) | 44,630,751 |

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

| | Unaudited June 30, 2008 | December 31, 2007 |
|--|---------------------------------------|------------------------------|
| | (In millions) | |
| ASSETS | | |
| Cash and cash equivalents | \$ 184 | \$ 277 |
| Restricted cash | 79 | 107 |
| Loans held for sale | 1 | 16 |
| Loans, net of allowance for losses of \$250 at June 30, 2008 and \$118 at December 31, 2007 | 9,995 | 9,928 |
| Securities available-for-sale | 1,357 | 1,882 |
| Securities held-to-maturity | 3,241 | 3,642 |
| Investment in Federal Home Loan Bank stock | 264 | 256 |
| Property and equipment, net | 235 | 233 |
| Accounts, notes, and accrued interest receivable | 81 | 97 |
| Goodwill | 144 | 144 |
| Other intangible assets | 24 | 26 |
| Deferred income taxes | 235 | 72 |
| Other assets | 191 | 116 |
| TOTAL ASSETS | \$ 16,031 | \$ 16,796 |
| LIABILITIES AND EQUITY | | |
| Deposits | \$ 9,160 | \$ 9,375 |
| Federal Home Loan Bank borrowings | 5,553 | 5,743 |
| Other liabilities | 142 | 125 |
| Subordinated notes payable to trust | 314 | 314 |
| Subordinated debentures and other borrowings | 76 | 101 |
| TOTAL LIABILITIES | 15,245 | 15,658 |
| STOCKHOLDERS EQUITY | | |
| Preferred stock, par value \$0.01 per share, 25 million shares authorized, none issued | | |
| Common stock, par value \$1 per share, 200 million shares authorized, 44.6 million shares at June 30, 2008 and 35.4 million shares at December 31, 2007 issued and outstanding | 45 | 35 |
| Additional paid-in-capital | 934 | 902 |
| Retained earnings | 141 | 236 |
| Accumulated other comprehensive loss, net | (334) | (35) |
| TOTAL STOCKHOLDERS EQUITY | 786 | 1,138 |

| | | |
|--|-----------|-----------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 16,031 | \$ 16,796 |
|--|-----------|-----------|

Please read the notes to the consolidated financial statements.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
Unaudited

| | Three Months Ended | | Six Months Ended | |
|---|--|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions, except per share) | | | |
| INTEREST INCOME | | | | |
| Loans and loans held for sale | \$ 131 | \$ 175 | \$ 282 | \$ 346 |
| Securities available-for-sale | 28 | 10 | 55 | 18 |
| Securities held-to-maturity | 41 | 57 | 88 | 117 |
| Federal Home Loan Bank stock dividends | 2 | 3 | 5 | 7 |
| Other earning assets | | 2 | | 2 |
| Total interest income | 202 | 247 | 430 | 490 |
| INTEREST EXPENSE | | | | |
| Deposits | (60) | (86) | (136) | (169) |
| Borrowed funds | (42) | (66) | (96) | (131) |
| Total interest expense | (102) | (152) | (232) | (300) |
| NET INTEREST INCOME | | | | |
| (Provision) credit for credit losses | 100 | 95 | 198 | 190 |
| | (99) | | (157) | 2 |
| NET INTEREST INCOME AFTER (PROVISION) CREDIT FOR CREDIT LOSSES | | | | |
| | 1 | 95 | 41 | 192 |
| NONINTEREST INCOME | | | | |
| Insurance commissions and fees | 17 | 16 | 36 | 32 |
| Service charges on deposits | 15 | 13 | 28 | 25 |
| Operating lease income | 1 | 2 | 3 | 4 |
| Other | 8 | 7 | 16 | 16 |
| Total noninterest income | 41 | 38 | 83 | 77 |
| NONINTEREST EXPENSE | | | | |
| Compensation and benefits | (48) | (43) | (99) | (91) |
| Occupancy | (9) | (7) | (17) | (13) |
| Information systems and technology | (4) | (4) | (9) | (7) |
| Charges related to asset impairments and severance | (3) | | (3) | |
| Other | (35) | (40) | (70) | (76) |
| Total noninterest expense | (99) | (94) | (198) | (187) |
| (LOSS) INCOME BEFORE TAXES | | | | |
| Income tax expense | (57) | 39 | (74) | 82 |
| | (28) | (15) | (21) | (31) |

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|---|----|--------|----|-----|----|--------|----|-----|
| NET (LOSS) INCOME | \$ | (85) | \$ | 24 | \$ | (95) | \$ | 51 |
| (LOSS) EARNINGS PER SHARE | | | | | | | | |
| Basic and diluted | \$ | (2.24) | | n/a | \$ | (2.59) | | n/a |
| AVERAGE NUMBER OF SHARES OUTSTANDING | | | | | | | | |
| Basic and diluted | | 38.0 | | n/a | | 36.8 | | n/a |

Please read the notes to the consolidated financial statements.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
Unaudited

| | Six Months Ended June 30, | |
|---|----------------------------------|-------------|
| | 2008 | 2007 |
| | (In millions) | |
| CASH PROVIDED BY (USED FOR) OPERATIONS | | |
| Net (loss) income | \$ (95) | \$ 51 |
| Adjustments: | | |
| Depreciation and amortization | 11 | 9 |
| Depreciation of assets leased to others | 3 | 3 |
| Amortization of core deposit and other intangible assets | 2 | 3 |
| Amortization and accretion of financial instrument discounts and premiums and deferred loan fees and origination costs, net | (2) | 10 |
| Provision (credit) for credit losses | 157 | (2) |
| Deferred income taxes | (2) | (6) |
| Changes in: | | |
| Loans held for sale | 15 | 3 |
| Other | (20) | (7) |
| | 69 | 64 |
| CASH PROVIDED BY (USED FOR) INVESTING | | |
| Securities available-for-sale: | | |
| Purchases | | (425) |
| Principal payments and maturities | 66 | 64 |
| Securities held-to-maturity: | | |
| Purchases | | (142) |
| Principal payments and maturities | 396 | 790 |
| Federal Home Loan Bank stock: | | |
| Purchases | (11) | |
| Redemption | 8 | 58 |
| Loans originated or acquired, net of collections | (262) | 125 |
| Sale of loans | 14 | 22 |
| Capital expenditures | (13) | (23) |
| Other | 8 | (3) |
| | 206 | 466 |
| CASH PROVIDED BY (USED FOR) FINANCING | | |
| Deposits, net | (215) | 46 |
| Repurchase agreements and short-term borrowings, net | (112) | (60) |
| Payments of long-term Federal Home Loan Bank and other borrowings | (78) | (434) |
| Issuance of subordinated notes payable to trust | | 172 |
| Redemption of preferred stock issued by subsidiaries | | (305) |
| Proceeds from sale of common stock | 38 | |

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| | | | | |
|--|----|-------|----|-------|
| Dividends paid to Temple-Inland Inc. | | | | (35) |
| Other | | (1) | | |
| | | (368) | | (616) |
| Net decrease in cash and cash equivalents | | (93) | | (86) |
| Cash and cash equivalents at beginning of period | | 277 | | 372 |
| Cash and cash equivalents at end of period | \$ | 184 | \$ | 286 |
| Interest paid | \$ | 228 | \$ | 303 |

Please read the notes to the consolidated financial statements.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Unaudited

| | Common Shares Outstanding | Additional Paid-in Stock Capital | Retained Earnings (In millions) | Accumulated Other Comprehensive Income net | Total Stockholders' Equity |
|---|---------------------------------|---|---------------------------------------|--|----------------------------------|
| Balance at December 31, 2007 | 35 | \$ 35 | \$ 902 | \$ 236 | \$ (35) \$ 1,138 |
| Net loss - first quarter 2008 | | | | (10) | (10) |
| Other comprehensive loss: | | | | | |
| Unrealized losses on available-for-sale securities | | | | (365) | (365) |
| Associated deferred taxes | | | | 128 | 128 |
| Comprehensive loss for three months ended March 31, 2008 | | | | | (247) |
| Share-based compensation, share-settled awards | | | 2 | | 2 |
| Issuance of shares upon vesting of restricted stock units | | | (1) | | (1) |
| Restricted stock grants | 2 | 2 | (2) | | |
| Balance at March 31, 2008 | 37 | \$ 37 | \$ 901 | \$ 226 | \$ (272) \$ 892 |
| Net loss - second quarter 2008 | | | | (85) | (85) |
| Other comprehensive loss: | | | | | |
| Unrealized losses on available-for-sale securities | | | | (94) | (94) |
| Associated deferred taxes | | | | 32 | 32 |
| Comprehensive loss for three months ended June 30, 2008 | | | | | (147) |
| Sale of common stock | 8 | 8 | 30 | | 38 |
| Share-based compensation, share-settled awards | | | 3 | | 3 |
| Balance at June 30, 2008 | 45 | \$ 45 | \$ 934 | \$ 141 | \$ (334) \$ 786 |
| Comprehensive loss for six months ended June 30, 2008 | | | | | \$ (394) |

Please read the notes to the consolidated financial statements.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1 Summary of Significant Accounting Policies

Background

Guaranty Financial Group Inc. (Guaranty, we, or our in these financial statements) is a grandfathered unitary savings and loan holding company that owns several subsidiaries, the most significant of which is Guaranty Bank, a federally-chartered savings bank. Guaranty Bank offers a broad range of retail banking services in two primary markets, Texas and California, and lends to business and commercial customers in target markets throughout the United States. Guaranty Bank also conducts insurance agency operations through its subsidiary, Guaranty Insurance Services, Inc.

Basis of Presentation

We prepare our unaudited interim financial statements in accordance with generally accepted accounting principles (GAAP) and Securities and Exchange Commission requirements for interim financial statements. As a result, we do not include all the information and disclosures required by GAAP for complete financial statements. However, in our opinion, we have included all adjustments considered necessary for a fair presentation. Our interim operating results are not necessarily indicative of the results that may be expected for the entire year. Actual results can, and probably will, differ from those we currently estimate. Examples of significant estimates include our allowance for credit losses, valuation of mortgage-backed securities and assessment of whether any impairment is other-than-temporary, ability to realize deferred tax assets, and our assessments of goodwill and other intangible assets for impairment. For further information, please read the financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

New Accounting Pronouncements

Effective January 1, 2008, we adopted Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measures* and SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS No. 159 permits an entity to elect fair value as the initial and subsequent measurement method for financial assets and liabilities. We have not elected the fair value option for any financial instruments. The adoption of SFAS No. 157 and SFAS No. 159 did not have a material impact on our financial statements. For more information about the fair value of our financial instruments, see **Note 13**.

Pending Accounting Pronouncements

SFAS No. 141 (revised 2007), *Business Combinations* This new standard retains the acquisition (purchase) method of accounting of SFAS No. 141, establishes the acquisition date as the date the acquirer achieves control, and requires assets acquired and liabilities assumed be measured at their fair values at that date. One implication of SFAS No. 141 to financial institutions is historical allowance for loan losses of the acquired entity will not be recorded by the acquiror; rather, the acquiror will record the loans at fair value, which will be reduced by the fair value of the credit risk inherent in those loans. SFAS No. 141 will be effective for us beginning January 1, 2009.

SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an Amendment of FASB Statement No. 133* This new standard expands disclosures about derivative instruments in financial statements. SFAS No. 161 will be effective for us beginning January 1, 2009. We are currently assessing the effect SFAS No. 161 will have on our financial statements, but anticipate it will only result in additional disclosures regarding derivative instruments, which are presently insignificant to us.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 2 Loans

Loans consist of:

| | June 30, 2008 | December 31, 2007 |
|---|--------------------------|------------------------------|
| | (In millions) | |
| Single-family mortgage | \$ 1,485 | \$ 1,672 |
| Single-family mortgage warehouse | 971 | 695 |
| Single-family construction (homebuilders) | 1,223 | 1,510 |
| Multifamily and senior housing | 1,877 | 1,541 |
| Commercial real estate | 1,774 | 1,674 |
| Commercial and business | 1,384 | 1,340 |
| Energy | 1,334 | 1,470 |
| Consumer and other | 197 | 144 |
| | | |
| Total loans | 10,245 | 10,046 |
| Less allowance for loan losses | (250) | (118) |
| | | |
| Loans, net | \$ 9,995 | \$ 9,928 |

Our single-family mortgage loans include \$407 million at June 30, 2008, and \$502 million at December 31, 2007, of adjustable-rate mortgages that have various monthly payment options (Option ARMs). We collected a net of \$1 million of previously deferred interest on Option ARMs in second quarter 2008 and \$3 million in first six months 2008. We recognized and added to the principal balance of Option ARMs \$1 million in interest income in second quarter 2007 and \$3 million in first six months 2007. Cumulative deferred unpaid interest on Option ARMs was \$19 million at June 30, 2008 and \$22 million at December 31, 2007.

At June 30, 2008, we had \$3.8 billion of unfunded commitments related to outstanding loans and \$280 million in commitments to originate loans. At June 30, 2008, we had outstanding standby letters of credit totaling \$338 million, which represent our obligation to guarantee payment of other entities' specified financial obligations or to make payments based on any failure by them to perform under an obligating agreement. The amount, if any, we will ultimately have to fund is uncertain, but we have not historically been required to fund a significant amount of letters of credit. At June 30, 2008, we did not have a significant amount of deferred fees related to letters of credit.

At June 30, 2008, we had \$1.1 billion of real estate construction loans and \$421 million of unfunded loan commitments to single-asset commercial real estate construction entities we believe meet the definition of a variable interest entity. Our involvement is as a lender in the customary form and we do not bear or benefit from the majority of the variability in cash flow or fair value of each entity's assets.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Activity in the allowance for credit losses was:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions) | | | |
| Allowance for loan losses: | | | | |
| Balance at beginning of period | \$ 172 | \$ 71 | \$ 118 | \$ 65 |
| Provision (credit) for loan losses | 97 | | 153 | (2) |
| Charge-offs | (20) | (2) | (23) | (3) |
| Recoveries | 1 | 3 | 2 | 12 |
| Balance at end of period | 250 | 72 | 250 | 72 |
| Unfunded credit commitments: | | | | |
| Balance at beginning of period | 9 | 7 | 7 | 7 |
| Provision for commitment-related credit losses | 2 | | 4 | |
| Balance at end of period | 11 | 7 | 11 | 7 |
| Combined allowances for credit losses at end of period | \$ 261 | \$ 79 | \$ 261 | \$ 79 |
| Provision (credit) for: | | | | |
| Loan losses | \$ 97 | \$ | \$ 153 | \$ (2) |
| Commitment-related credit losses | 2 | | 4 | |
| Combined provision (credit) for credit losses | \$ 99 | \$ | \$ 157 | \$ (2) |

Information about the unpaid principal balance of past due, nonaccrual, restructured, and impaired loans follows:

| | June 30, 2008 | December 31, 2007 |
|--|--------------------------|----------------------------------|
| | (In millions) | |
| Accruing loans past due 90 days or more | \$ 5 | \$ 6 |
| Recorded investment in nonaccrual loans | 364 | 166 |
| Restructured troubled loans included in nonaccrual loans | 1 | 1 |
| Impaired loans included in nonaccrual loans | 245 | 118 |
| Allowance for loan losses on impaired loans | 104 | 20 |
| Performing restructured troubled loans | 3 | |

Our nonaccrual loans at June 30, 2008 include \$233 million of single-family construction (homebuilder) loans and \$97 million of single-family mortgage loans. We did not recognize a significant amount of interest income on impaired loans in the first six months 2008 or 2007. Interest income we would have recognized on nonaccrual loans,

had they been performing in accordance with contractual terms, was \$6 million in second quarter 2008, \$11 million in first six months 2008 and was not significant in second quarter 2007 or first six months 2007.

Foreclosed assets were \$42 million at June 30, 2008 and \$13 million at December 31, 2007. We expect foreclosed assets to increase significantly in third quarter 2008.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 3 Securities

Securities consist of:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---|-------------------|------------------------------|---------------------------------|------------|
| | (In millions) | | | |
| At June 30, 2008: | | | | |
| Available-for-sale | | | | |
| Mortgage-backed securities: | | | | |
| U.S. Government | \$ 12 | \$ | \$ | \$ 12 |
| U.S. Government Sponsored Enterprises (FNMA, FHLMC) | 507 | 4 | (3) | 508 |
| Non-agency | 1,347 | | (514) | 833 |
| | 1,866 | 4 | (517) | 1,353 |
| Equity securities | 4 | | | 4 |
| | \$ 1,870 | \$ 4 | \$ (517) | \$ 1,357 |
| Held-to-maturity | | | | |
| Mortgage-backed securities: | | | | |
| U.S. Government | \$ 50 | \$ | \$ (1) | \$ 49 |
| U.S. Government Sponsored Enterprises (FNMA, FHLMC) | 908 | 6 | (1) | 913 |
| Non-agency | 2,283 | | (902) | 1,381 |
| | \$ 3,241 | \$ 6 | \$ (904) | \$ 2,343 |
| At December 31, 2007: | | | | |
| Available-for-sale | | | | |
| Mortgage-backed securities: | | | | |
| U.S. Government | \$ 14 | \$ | \$ | \$ 14 |
| U.S. Government Sponsored Enterprises (FNMA, FHLMC) | 552 | 4 | (4) | 552 |
| Non-agency | 1,366 | | (54) | 1,312 |
| | 1,932 | 4 | (58) | 1,878 |
| Equity securities | 4 | | | 4 |
| | \$ 1,936 | \$ 4 | \$ (58) | \$ 1,882 |
| Held-to-maturity | | | | |
| Mortgage-backed securities: | | | | |
| U.S. Government | \$ 57 | \$ | \$ | \$ 57 |
| U.S. Government Sponsored Enterprises (FNMA, FHLMC) | 1,172 | 4 | (3) | 1,173 |
| Non-agency | 2,413 | 1 | (213) | 2,201 |

\$ 3,642 \$ 5 \$ (216) \$ 3,431

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GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

A significant amount of the mortgage-backed securities we own have Option ARMs as the underlying assets. None of the securities include sub-prime loans as underlying assets. The amortized cost at June 30, 2008 of securities in our portfolio with Option ARMs as the underlying assets was \$4.0 billion. Of these, \$540 million were issued by U.S. Government Sponsored Enterprises (FNMA, FHLMC) and the remaining \$3.5 billion are senior or senior-support tranches issued by non-agency institutions.

As of June 30, 2008, all of the non-agency securities we own carried AAA ratings by two different nationally recognized securities rating organizations. Subsequent to second quarter end, one rating organization downgraded one of the non-agency securities, which had an amortized cost of \$56 million at June 30, 2008, to single-A. Additionally, nine other non-agency securities we own, with a cumulative amortized cost of \$1.0 billion, have been placed on negative watch status by one or both of those rating organizations.

We consider all of the unrealized losses on the securities we own to be temporary because:

The securities cannot be settled at maturity or through prepayment in a way precluding recovery of substantially all of our recorded investment. We do not have significant purchase premiums on the securities.

We have no specific plans to sell these securities and we have the ability and intent to hold them until repayment.

We believe, based on our current estimates of cash flows on the securities, we will receive all stated interest and principal. Each of the non-agency securities is credit-enhanced by subordinate tranches not owned by us, which will absorb credit losses of the underlying loans until those tranches are depleted. We currently estimate the credit losses on the underlying loans will not exceed those subordinate tranches and, therefore, our securities will not incur credit losses.

See **Note 13** for disclosures about our fair value estimates.

Note 4 Deposits

Deposits consist of:

| | June 30, 2008 | December 31, 2007 |
|----------------------------|------------------|----------------------|
| | (In millions) | |
| Noninterest-bearing demand | \$ 566 | \$ 779 |
| Interest-bearing demand | 4,058 | 3,648 |
| Savings deposits | 179 | 172 |
| Certificates of deposit | 4,357 | 4,776 |
| | \$ 9,160 | \$ 9,375 |

Approximately \$1.9 billion (21%) of our deposits at June 30, 2008 were above the federal deposit insurance limits, of which \$1.6 billion were transaction accounts and \$300 million were certificates of deposit.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 5 Borrowings

Information about our short-term (original maturities of 12 months or less) and long-term (original maturities greater than 12 months) Federal Home Loan Bank (FHLB) borrowings and other borrowings follows:

| | June 30, 2008 | | December 31, 2007 | |
|--|----------------------|---|--------------------------|---|
| | Balance | Weighted Average Interest Rate (Dollars in millions) | Balance | Weighted Average Interest Rate |
| Short-term FHLB borrowings | \$ 4,837 | 2.2% | \$ 4,949 | 4.3% |
| Long-term FHLB borrowings | 716 | 4.3% | 794 | 4.2% |
| Subordinated notes payable to trust | 314 | 4.5% | 314 | 7.2% |
| Subordinated debentures and other borrowings | 76 | 5.9% | 101 | 8.5% |

In second quarter 2008, we redeemed \$25 million of our subordinated debentures using restricted cash we had placed on deposit with the trustee for the debentures in 2007.

Interest expense on borrowings consists of:

| | Three Months Ended June 30, 2008 | | Six Months Ended June 30, 2008 | | Six Months Ended June 30, 2007 | |
|--|---|-------------|---|-------------|---|-------------|
| | 2008 | 2007 | 2008 | 2008 | 2007 | 2007 |
| | (In millions) | | | | | |
| Short-term FHLB borrowings | \$ 28 | \$ 48 | \$ 67 | \$ 93 | | |
| Long-term FHLB borrowings | 8 | 8 | 16 | 18 | | |
| Subordinated notes payable to trust | 4 | 5 | 9 | 8 | | |
| Subordinated debentures and other borrowings | 2 | 3 | 4 | 5 | | |
| Preferred stock issued by subsidiaries | | 2 | | 7 | | |
| | \$ 42 | \$ 66 | \$ 96 | \$ 131 | | |

At June 30, 2008, \$11 billion in principal balance of our loans and securities were pledged as collateral for FHLB borrowings.

Subsequent to June 30, 2008, we terminated our revolving credit facility. We had not drawn any amounts under the revolving credit facility.

Note 6 (Loss) Earnings Per Share

We compute (loss) earnings per share by dividing net (loss) income by the weighted average shares outstanding as follows:

| | Three Months Ended June 30, 2008 | | Six Months Ended June 30, 2008 | | Six Months Ended June 30, 2007 | |
|---|---|-------------|---|-------------|---|-------------|
| | 2008 | 2007 | 2008 | 2008 | 2007 | 2007 |
| | (In millions, except per share) | | | | | |
| Net (loss) income | \$ (85) | \$ 24 | \$ (95) | \$ 51 | | |
| Weighted average shares outstanding basic and diluted | 38.0 | n/a | 36.8 | n/a | | |

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(Loss) earnings per common share basic and diluted \$ (2.24) n/a \$ (2.59) n/a

We have not included outstanding option awards or unvested restricted stock in our diluted weighted average shares outstanding calculations for 2008 because those items would have been anti-dilutive as a result of our net loss. Because our stock was not distributed by Temple-Inland Inc. until December 28, 2007, we do not present earnings per share under GAAP for 2007. Had our stock been outstanding in second quarter 2007 and first six months 2007 in the amount distributed by Temple-Inland Inc., basic earnings per share would have been \$0.68 and \$1.44 (*proforma*).

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

At June 30, 2008, Temple-Inland Inc. and Forestar Real Estate Group Inc. directors and employees held 82 thousand stock-settled units on our stock. The following information summarizes outstanding stock option awards on our stock held by Temple-Inland Inc. and Forestar Real Estate Group Inc. directors and employees at June 30, 2008:

| | Shares (In thousands) | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term (In years) | Aggregate Intrinsic Value (Current Value Less Exercise Price) (In millions) |
|-------------|-----------------------------|---|---|--|
| Outstanding | 1,609 | \$ 12 | 5 | \$ |
| Exercisable | 1,278 | 11 | 5 | |

Note 7 Income Taxes

A reconciliation of the federal statutory rate to our effective income tax rate follows:

| | Three Months Ended June | | Six Months Ended June | |
|--|-------------------------|------|-----------------------|------|
| | 30, 2008 | 2007 | 30, 2008 | 2007 |
| Federal statutory rate | 35% | 35% | 35% | 35% |
| State taxes, net of federal benefit | (2)% | 3% | | 3% |
| Valuation allowance on deferred tax assets | (80)% | | (62)% | |
| Other | (2)% | | (1)% | |
| | (49)% | 38% | (28)% | 38% |

We file income tax returns in the U.S. federal jurisdiction and various states. With few exceptions, we are no longer subject to U.S. federal, state, and local income tax examinations by authorities for years before 2004. Because of timing differences between when expenses are recognized under GAAP and when items become deductible on our tax returns, we may pay taxes in a period in which we report a net loss under GAAP.

Significant components of our deferred taxes are:

| | June 30, 2008 | December 31, 2007 |
|--|------------------|----------------------|
| | (In millions) | |
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 85 | \$ 41 |
| Unrealized losses on available-for-sale securities | 179 | 19 |
| Other | 47 | 39 |
| | 311 | 99 |

Deferred tax liabilities:

| | | |
|--|--------|-------|
| Investment in FHLB stock | (19) | (18) |
| Other | (11) | (9) |
| | (30) | (27) |
| Net deferred tax asset before valuation allowance | 281 | 72 |
| Valuation allowance | (46) | |
| Net deferred tax asset | \$ 235 | \$ 72 |

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not we will be able to realize the deferred tax assets. The terms of our separation agreements with Temple-Inland Inc. prohibit us from carrying back any net operating tax losses to periods prior to 2008. Therefore, our ability to realize deferred tax assets depends upon our tax planning strategies, including holding available-for-sale securities to maturity, and our generation of taxable income in periods after 2007. We consider deferred tax assets related to the unrealized losses on available-for-sale mortgage-backed securities more likely than not to be realized because we expect the temporary differences to reverse without resulting in tax losses. We currently believe it is more likely than not we will realize \$86 million of the other deferred tax assets. As a result, we recorded a \$46 million valuation allowance in second quarter 2008.

Note 8 Litigation

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business and believe we have established adequate reserves for any probable losses. We do not believe the outcome

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

of any of these proceedings will have a significant adverse effect on our financial position, long-term results of operations, or cash flow. It is possible, however, charges related to these matters could be significant to our results or cash flow in any one period.

A class action in California, related to our former mortgage banking operations, was dismissed but remains under appeal by the plaintiff. We have established reserves we believe are adequate for this matter, and do not anticipate the outcome will have a significant adverse effect on our financial position or results of operations or cash flow.

As a result of our participation in the Visa USA (Visa) network, principally related to ATM and debit cards, we own 33 thousand Class B common shares of Visa for which we have no carrying value. As a former member of Visa, we participate in an indemnification provision in Visa s bylaws. We are not a named defendant in any of Visa s litigation matters, and have no access to any non-public information about the matters.

Note 9 Segment Information

We currently operate in four business segments:

Commercial banking,

Retail banking,

Insurance agency, and

Treasury, corporate and other.

We evaluate performance based on income before taxes and unallocated expenses. Unallocated expenses represent expenses managed on a company-wide basis and include share-based compensation, charges related to asset impairments and severance, and prior to 2008, other expenses allocated to us by Temple-Inland Inc. but not directly attributable to us. Our internal management reporting for operating segments has not changed significantly from December 31, 2007.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

| | Commercial Banking | Retail Banking | Insurance Agency | Mortgage Banking | Treasury, Corporate and Other | Total |
|---|-----------------------|-------------------|---------------------|---------------------|-------------------------------------|-----------|
| | (In millions) | | | | | |
| For the Three Months Ended | | | | | | |
| June 30, 2008: | | | | | | |
| Net interest income | \$ 68 | \$ 20 | \$ | \$ | \$ 12 | \$ 100 |
| (Provision) credit for credit losses | (86) | (1) | | | (12) | (99) |
| Noninterest income | 7 | 15 | 17 | | 2 | 41 |
| Revenues from other segments | | 4 | | | (4) | |
| Noninterest expense | (19) | (55) | (16) | (1) | (8) ^(a) | (99) |
| Segment operating income/(loss) before taxes | \$ (30) | \$ (17) | \$ 1 | \$ (1) | \$ (10) | \$ (57) |
| Average assets | \$ 10,287 | \$ 647 | \$ 89 | \$ 31 | \$ 5,309 | \$ 16,363 |
| Goodwill | | 106 | 38 | | | 144 |
| Depreciation and amortization | 2 | 4 | | | 1 | 7 |
| Capital expenditures | | 4 | | | 1 | 5 |
| For the Three Months Ended | | | | | | |
| June 30, 2007: | | | | | | |
| Net interest income | \$ 69 | \$ 30 | \$ | \$ | \$ (4) | \$ 95 |
| (Provision) credit for credit losses | (1) | (1) | | | 2 | |
| Noninterest income | 8 | 14 | 16 | | | 38 |
| Revenues from other segments | | 2 | | | (2) | |
| Noninterest expense | (18) | (53) | (14) | (7) | (2) ^(a) | (94) |
| Segment operating income/(loss) before taxes | \$ 58 | \$ (8) | \$ 2 | \$ (7) | \$ (6) | \$ 39 |
| Average assets | \$ 9,656 | \$ 609 | \$ 94 | \$ 47 | \$ 5,387 | \$ 15,793 |
| Goodwill | | 107 | 34 | | | 141 |
| Depreciation and amortization | 2 | 3 | | | 3 | 8 |
| Capital expenditures | 3 | 2 | 1 | | 4 | 10 |
| For the Six Months Ended June 30, | | | | | | |
| 2008: | | | | | | |
| Net interest income | \$ 137 | \$ 41 | \$ | \$ | \$ 20 | \$ 198 |
| (Provision) credit for credit losses | (138) | (2) | | | (17) | (157) |
| Noninterest income | 14 | 30 | 36 | | 3 | 83 |
| Revenues from other segments | | 8 | | | (8) | |
| Noninterest expense | (37) | (114) | (34) | (2) | (11) ^(a) | (198) |
| Segment operating income/(loss) before taxes | \$ (24) | \$ (37) | \$ 2 | \$ (2) | \$ (13) | \$ (74) |
| Average assets | \$ 10,139 | \$ 634 | \$ 89 | \$ 32 | \$ 5,529 | \$ 16,423 |
| Goodwill | | 106 | 38 | | | 144 |
| Depreciation and amortization | 4 | 9 | 1 | | 2 | 16 |

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| | | | | | | |
|--|----------|---------|-------|--------|--------------------|-----------|
| Capital expenditures | 1 | 10 | | | 2 | 13 |
| For the Six Months Ended June 30, 2007: | | | | | | |
| Net interest income | \$ 138 | \$ 60 | \$ | \$ | \$ (8) | \$ 190 |
| (Provision) credit for credit losses | 2 | (1) | | | 1 | 2 |
| Noninterest income | 17 | 28 | 32 | | | 77 |
| Revenues from other segments | | 4 | | | (4) | |
| Noninterest expense | (36) | (106) | (28) | (8) | (9) ^(a) | (187) |
| Segment operating income/(loss) | | | | | | |
| before taxes | \$ 121 | \$ (15) | \$ 4 | \$ (8) | \$ (20) | \$ 82 |
| Average assets | \$ 9,607 | \$ 606 | \$ 93 | \$ 48 | \$ 5,372 | \$ 15,726 |
| Goodwill | | 107 | 34 | | | 141 |
| Depreciation and amortization | 4 | 7 | 1 | | 3 | 15 |
| Capital expenditures | 3 | 15 | 1 | | 4 | 23 |

(a) Includes unallocated expenses of:

| | Three Months | | Six Months | |
|--|----------------------------|-------------|----------------------------|-------------|
| | Ended June 30, 2008 | | Ended June 30, 2007 | |
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions) | | | |
| Share-based compensation | \$ (3) | \$ (1) | \$ (4) | \$ (4) |
| Charges related to asset impairments and severance | (3) | | (3) | |
| Expenses allocated to us by Temple-Inland Inc. but not directly attributable to us | | (2) | | (5) |
| Other | (2) | 1 | (4) | |
| | \$ (8) | \$ (2) | \$ (11) | \$ (9) |

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 10 Noninterest Expense

We expensed \$3 million, and paid \$2 million, in severance in second quarter 2008 related to a reduction-in-force. Other noninterest expense consists of:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions) | | | |
| Advertising and promotional | \$ 4 | \$ 3 | \$ 11 | \$ 7 |
| Furniture, fixtures, and equipment | 5 | 4 | 11 | 8 |
| Professional services | 5 | 2 | 8 | 4 |
| Travel and other employee costs | 4 | 3 | 6 | 5 |
| Postage, printing, and supplies | 2 | 2 | 4 | 4 |
| Litigation charge | | 5 | | 5 |
| Depreciation of assets leased to others | 2 | 1 | 3 | 3 |
| Other | 13 | 13 | 27 | 25 |
| Shared services allocation from Temple-Inland Inc. | | 7 | | 15 |
| | \$ 35 | \$ 40 | \$ 70 | \$ 76 |

Note 11 Share-Based Compensation

We have stockholder approved share-based compensation plans permitting awards to key employees and non-employee directors of stock-based awards, including restricted stock and options to purchase shares of our common stock. We generally grant awards annually in February.

Share-based compensation expense consists of:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------|--------------------------------|--------|------------------------------|------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions) | | | |
| Restricted stock | \$ 3 | \$ (1) | \$ 4 | \$ |
| Cash-settled awards | | 1 | (1) | 2 |
| Stock options | | 1 | 1 | 2 |
| | \$ 3 | \$ 1 | \$ 4 | \$ 4 |

Cash-settled award compensation expense is dependent on the price of the underlying shares and can vary significantly. The fair value, and related compensation expense, of restricted stock and stock options are determined at the date of grant and do not typically change for subsequent changes in share price.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Cash-settled awards

A summary of cash-settled awards outstanding to our employees at June 30, 2008 follows:

| | Equivalent Shares (In thousands) | Aggregate Current Value (In millions) |
|---|---|--|
| Awards indexed to Guaranty stock | 81 | \$ |
| Awards indexed to Temple-Inland Inc. stock | 244 | 3 |
| Awards indexed to Forestar Real Estate Group Inc. stock | 81 | 2 |
| | | \$ 5 |

Restricted stock and stock-settled units

During first quarter 2008, we granted 1.6 million shares of restricted stock to our directors and employees, valued at \$23 million at the date of grant. We recognize the value of shares granted to employees in expense over vesting periods ranging from three to four years. Shares granted to directors are immediately vested and we include them in expense at the grant date. Certain of the awards contain performance conditions, which we currently estimate will be achieved for purposes of determining compensation expense. During second quarter 2008, we granted 56 thousand shares of restricted stock units, valued at less than \$1 million, to our directors as compensation for meeting attendance, in lieu of cash compensation for those meetings.

The following information summarizes outstanding restricted stock awards on our stock held by our directors and employees at June 30, 2008:

| | Shares (In thousands) | Aggregate Current Value (In millions) |
|----------------------------------|--------------------------------------|--|
| Outstanding at December 31, 2007 | 26 | |
| Granted | 1,647 | |
| Cancelled | (22) | |
| Outstanding at March 31, 2008 | 1,651 | |
| Granted | 56 | |
| Cancelled | (36) | |
| Outstanding at June 30, 2008 | 1,671 | \$ 9 |

Stock Options

The following information summarizes outstanding stock option awards held by our directors and employees at June 30, 2008:

Weighted Aggregate

| | Shares (In thousands) | Weighted Average Exercise Price Per Share | Average Remaining Contractual Term (In years) | Intrinsic Value (Current Value Less Exercise Price) (In millions) |
|--|-----------------------------|---|---|--|
| Outstanding on Guaranty stock | 313 | \$ 14 | 6 | \$ |
| Outstanding on Temple-Inland Inc. stock | 947 | 17 | 6 | 1 |
| Outstanding on Forestar Real Estate Group Inc. stock | 310 | 22 | 6 | 1 |
| | | | | \$ 2 |
| Exercisable on Guaranty stock | 201 | \$ 12 | 6 | \$ |
| Exercisable on Temple-Inland Inc. stock | 610 | 14 | 5 | 1 |
| Exercisable on Forestar Real Estate Group Inc. stock | 198 | 18 | 6 | 1 |
| | | | | \$ 2 |

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 12 Benefit Plans

We recorded \$2 million in expense in second quarter 2008 and \$4 million in expense in first six months 2008 for contributions to our 401(k) plan.

Note 13 Fair Value of Financial Instruments

The carrying value and estimated fair value of financial instruments not carried at fair value in our balance sheet were as follows:

| | June 30, 2008 | | December 31, 2007 | |
|---|-------------------|---------------|-------------------|---------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| | (In millions) | | | |
| Financial assets | | | | |
| Loans, net | \$ 9,995 | \$ 9,722 | \$ 9,928 | \$ 9,940 |
| Mortgage-backed securities held-to-maturity: | | | | |
| U.S. Government and U.S. Government Sponsored Enterprises | 958 | 962 | 1,229 | 1,230 |
| Non-agency: | | | | |
| Internally valued | 2,116 | 1,217 | 2,214 | 2,002 |
| Market quotes | 167 | 164 | 199 | 199 |
| | 3,241 | 2,343 | 3,642 | 3,431 |
| Financial liabilities | | | | |
| Deposits | \$ 9,160 | \$ 9,168 | \$ 9,375 | \$ 9,381 |
| Federal Home Loan Bank borrowings | 5,553 | 5,562 | 5,743 | 5,747 |
| Subordinated notes payable to trust | 314 | 277 | 314 | 277 |
| Subordinated debentures and other borrowings | 76 | 76 | 101 | 101 |
| Other off-balance sheet instruments | | | | |
| Commitments to extend credit | \$ (11) | \$ (11) | \$ (7) | \$ (7) |

SFAS No. 157 establishes a hierarchy of fair value determination methods reflecting the observability of the information underlying the determination:

Level 1 is observable prices in active markets.

Level 2 is observable prices in less than active markets or for different, but similar products, or valuation methodologies using observable data.

Level 3 is valuation methodologies using data not observable in the markets.

Very little actual trading is occurring in non-agency securities and we have little visibility of actual trading prices. We estimate the fair value of the non-agency securities we own using internal valuation techniques, and incorporate sample market value estimates from securities dealers and other third-party information in applying those techniques. Securities dealer market value estimates for these types of securities are generally accompanied by statements that the estimates do not necessarily reflect actual market transactions, and other disclaimers. As a result, we consider our fair value estimates for non-agency securities to be Level 3. The estimated market values of the non-agency securities we own would result in yields to maturity from 15% to 38% based on our estimates of expected future cash flows on those securities.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

The fair value of financial instruments measured at fair value on a recurring basis, categorized in terms of SFAS No. 157 valuation criteria, at June 30, 2008 follows:

| | Level 1 | Level 3 (In millions) | Total |
|--|--------------------|----------------------------------|--------------|
| Available-for-sale securities: | | | |
| U.S. Government and U.S. Government Sponsored Enterprises mortgage-backed securities | \$ 520 | \$ | \$ 520 |
| Non-agency mortgage-backed securities | | 833 | 833 |
| Equity securities | | 4 | 4 |
| | \$ 520 | \$ 837 | \$ 1,357 |

Changes in the fair value of financial instruments measured at fair value on a recurring basis using Level 3 information are summarized as follows:

| | Three Months Ended June 30, 2008 | Six Months Ended June 30, 2008 |
|---|---|---|
| | (In millions) | |
| Recorded amount at beginning of the period | \$ 942 | \$ 1,316 |
| Change in unrealized losses for the period included in other comprehensive loss | (94) | (459) |
| Principal payments | (11) | (20) |
| Recorded amount at end of period | \$ 837 | \$ 837 |

We measure certain assets at fair value on a nonrecurring basis. Fair value measurement for those assets usually results from asset impairment or lower-of-cost-or-market accounting. The fair value of assets measured at fair value on a nonrecurring basis, categorized in terms of SFAS No. 157 valuation criteria, at June 30, 2008 follows:

| | Level 2 (In millions) |
|-------------------|--------------------------------------|
| Impaired loans | \$ 141 |
| Foreclosed assets | 42 |
| | \$ 183 |

Note 14 Transactions with Temple-Inland Inc.

A summary of transactions with Temple-Inland Inc. during 2007 when it was a related party (we do not consider Temple-Inland Inc. to be a related party following our spin-off), all of which were allocated expenses, follows:

| | Three Months Ended June 30, 2007 | Six Months Ended June 30, 2007 |
|---|---|---|
| | (In millions) | |
| Information technology support | \$ 4 | \$ 8 |
| Legal, human resources, and other administrative costs | 1 | 3 |
| Accounting, finance, and other | 2 | 4 |
| Share-based compensation (included in compensation expense) | 1 | 4 |
| | \$ 8 | \$ 19 |

We charge Temple-Inland Inc. for rent, taxes, insurance, and utilities in accordance with the terms of an operating lease agreement, and for insurance management services. During second quarter 2007, we billed Temple-Inland Inc. \$2 million for these services and \$4 million in first six months 2007.

GUARANTY FINANCIAL GROUP INC. AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

Note 15 Subsequent Events

Capital Raising Activities

In second quarter 2008, we entered into agreements to sell 6.2 million shares of our authorized convertible preferred stock and \$275 million par value of subordinated debt of Guaranty Bank for aggregate proceeds of \$562 million, before deduction of \$23 million in offering costs. Issuance of the convertible preferred stock and subordinated debt was subject to regulatory approvals, which we obtained subsequent to June 30, 2008. In July 2008, we issued the convertible preferred stock and subordinated debt to the investors. We used the proceeds to repay FHLB borrowings. Substantially all of the net proceeds will qualify as regulatory capital for Guaranty Bank. Including the proceeds from these transactions, our proforma regulatory capital ratios at June 30, 2008 would have been approximately 9.49% Tier 1 (Core) Leverage Ratio and 14.62% Total Risk-Based Ratio.

The convertible preferred stock is convertible to our common stock at an initial conversion price of one common share for each \$5.17 of stated value (10 shares of common stock for each share of convertible preferred stock), and conversion is mandatory upon approval by our stockholders. Until converted, the convertible preferred stock accrues dividends at a rate of 14% per year, which, if unpaid at time of conversion, are mandatorily converted to common stock at the same conversion price as the convertible preferred stock. The conversion price decreases by \$.50 (resulting in additional common shares for each share of convertible preferred stock) subject to a minimum conversion price of \$3.00 per share, and the dividend rate increases 2% (subject to a maximum rate of 18% per year) every 6 months after November 2008 if our stockholders do not approve the conversion. We expect to seek stockholder approval prior to November 2008. If the convertible preferred stock had been outstanding during the entire second quarter 2008 and been dilutive to our per share results, it would have increased our weighted average diluted shares by 62 million.

The subordinated debt accrues interest at 12% per year and has a 10 year maturity. We are entitled to call the subordinated debt after five years.

In second quarter 2008, we entered into an Investment Agreement with TRT Financial Holdings, LLC under which TRT Financial Holdings, LLC purchased approximately 7.4 million shares of our common stock for \$38 million. Under the terms of the Investment Agreement, 120 days following the closing of the Investment Agreement, TRT Financial Holdings, LLC will purchase a number of shares of a series of convertible preferred stock, with similar terms and attributes as the preferred stock above, such that TRT Financial Holdings, LLC will beneficially own 19.9% of our total outstanding common stock, assuming full conversion of the preferred stock.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are identified by their use of terms and phrases such as believe, anticipate, could, estimate, likely, intend, may, plan, project, expect, expressions, including references to assumptions or our plans and goals. These statements reflect our current views with respect to future events and are subject to risk and uncertainties. A variety of factors and uncertainties could cause our actual results to differ significantly from the results discussed in the forward-looking statements. Factors and uncertainties that might cause such differences include, but are not limited to:

general economic, market or business conditions;

demand for new housing;

competitive actions by other companies;

changes in laws or regulations and actions or restrictions of regulatory agencies;

deposit attrition, customer loss, or revenue loss in the ordinary course of business;

costs or difficulties related to transitioning as a stand-alone public company following our spin-off from Temple-Inland Inc. in December 2007;

inability to realize elements of our strategic plans;

changes in the interest rate environment that expand or reduce margins or adversely affect critical estimates and projected returns on investments;

unfavorable changes in economic conditions affecting housing markets, credit markets, real estate values, or oil and gas prices, either nationally or regionally;

natural disasters in primary market areas that may result in prolonged business disruption or impair the value of collateral securing loans;

assumptions and estimates underlying critical accounting policies, particularly allowance for credit losses, mortgage-backed securities valuation and impairment assessments, ability to realize deferred tax assets, and goodwill and other intangible impairment assessments, that may prove to be materially incorrect or may not be borne out by subsequent events;

current or future litigation, regulatory investigations, proceedings or inquiries;

strategies to manage interest rate risk, that may yield results other than those anticipated;

a significant change in the rate of inflation or deflation;

changes in the securities markets;

the ability to complete any merger, acquisition or divestiture plans; regulatory or other limitations imposed as a result of any merger, acquisition or divestiture; and the success of our business following any merger, acquisition or divestiture;

the final resolutions or outcomes with respect to our contingent and other corporate liabilities related to our business and any related actions for indemnification made pursuant to the various agreements with Temple-Inland Inc. and Forestar Real Estate Group Inc.;

the ability to maintain capital ratios acceptable to the Office of Thrift Supervision; and

changes in the value of real estate securing our loans.

Other factors, including the Risk Factors described in Part II, may also cause actual results to differ materially from those projected by our forward-looking statements. New factors emerge from time to time and it is not possible for us to predict all such factors, nor can we assess the impact of any such factor on our business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement.

Any forward-looking statement speaks only as of the date on which such statement is made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Selected Ratios and Other Data (unaudited)

| | Three Months Ended | | | | | Six Months Ended | |
|---|--|-------------------------------|----------------------------------|-----------------------------------|------------------------------|------------------------------|------------------------------|
| | June 30, 2008 | March 31, 2008 | December 31, 2007 | September 30, 2007 | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| | (Dollars in millions, except per share) | | | | | | |
| For the period: | | | | | | | |
| Net interest income | \$ 100 | \$ 98 | \$ 102 | \$ 99 | \$ 95 | \$ 198 | \$ 190 |
| (Provision) credit for credit losses | (99) | (58) | (33) | (19) | | (157) | 2 |
| Net (loss) income | (85) | (10) | 6 | 21 | 24 | (95) | 51 |
| Net (charge-offs) recoveries | (19) | (2) | (6) | | 1 | (21) | 9 |
| Return on average assets | (2.08)% | (0.24)% | 0.15% | 0.53% | 0.61% | (1.16)% | 0.65% |
| Return on average stockholders equity | (37.12)% | (3.65)% | 2.28% | 8.06% | 9.38% | (18.43)% | 9.94% |
| Net interest margin | 2.54% | 2.49% | 2.59% | 2.65% | 2.55% | 2.51% | 2.55% |
| Period-end: | | | | | | | |
| Loans, net | \$ 9,995 | \$ 10,099 | \$ 9,928 | \$ 9,561 | \$ 9,470 | | |
| Non-performing assets | 406 | 284 | 179 | 130 | 36 | | |
| Non-performing assets ratio | 3.95% | 2.76% | 1.78% | 1.35% | 0.38% | | |
| Capital/Equity (actual): | | | | | | | |
| Guaranty Bank tier 1 leverage ratio | 7.63% | 7.58% | 7.74% | 7.79% | 8.07% | | |
| Guaranty Bank tier 1 risk-based ratio | 9.36% | 9.38% | 9.63% | 9.94% | 10.00% | | |
| Guaranty Bank total risk-based capital ratio | 10.60% | 10.61% | 10.54% | 10.68% | 10.61% | | |
| Tangible equity/tangible assets | 3.90% | 4.45% | 5.82% | 5.36% | 5.60% | | |
| Tangible equity/per common share | \$ 13.85 | \$ 19.38 | \$ 27.36 | n/a | n/a | | |
| Capital/Equity (proforma)⁽¹⁾: | | | | | | | |
| Guaranty Bank tier 1 leverage ratio | 9.49% | n/a | n/a | n/a | n/a | | |
| Guaranty Bank tier 1 risk-based ratio | 11.64% | n/a | n/a | n/a | n/a | | |
| Guaranty Bank total risk-based capital | 14.62% | n/a | n/a | n/a | n/a | | |

| | | | | | | | |
|---|----------|----------|----------|----------|----------|----------|----------|
| ratio | | | | | | | |
| Tangible equity/tangible assets | 5.86% | | | | | | |
| Tangible equity/per common share | \$ 8.74 | n/a | n/a | n/a | n/a | | |
| Credit reserves: | | | | | | | |
| Allowance for loan losses | \$ 250 | \$ 172 | \$ 118 | \$ 91 | \$ 72 | | |
| Allowance for loan losses to total loans | 2.44% | 1.67% | 1.17% | 0.94% | 0.75% | | |
| Allowance for loan losses to non-performing loans | 69% | 66% | 71% | 75% | 248% | | |
| Total deposits | \$ 9,160 | \$ 9,248 | \$ 9,375 | \$ 9,376 | \$ 9,532 | | |
| Average interest-bearing deposits | 8,405 | 8,588 | 8,609 | 8,794 | 8,777 | \$ 8,496 | \$ 8,704 |
| Total branches | 162 | 158 | 158 | 159 | 156 | | |

(1) Proforma capital/equity ratios at June 30, 2008 reflect the effect we anticipate of the proceeds from our issuance of mandatorily convertible preferred stock and subordinated debt in July 2008, and present those amounts as if the preferred stock had been converted to common stock.

Current Market Conditions

Current conditions in the credit markets are difficult and volatile. Liquidity for non-agency investment securities is virtually non-existent, and there is a lack of price transparency for many securitized assets. As a result, credit availability for many potential borrowers has been dramatically reduced. In addition, and partly as a result, current conditions in residential housing markets are poor and worsening. In many markets there is an oversupply of housing, including significant increases in foreclosed properties being marketed, and decreasing demand. Homebuilders have found it difficult to sell new homes and many local and regional homebuilders are facing severe liquidity challenges resulting in their inability to complete land development projects and homes under construction. Declining economic

conditions are increasing the number of homeowners unable to make required payments on loans, and declining values in many markets have made it difficult for borrowers to refinance when variable rate loan payments exceed their ability to service the loans.

These conditions have negatively affected our investment securities and loan portfolios, particularly non-agency mortgage-backed securities, loans to homebuilders, and single-family mortgage loans. At June 30, 2008, the estimated fair value of the non-agency securities we own was below amortized cost by approximately \$1.4 billion, or 39%. At June 30, 2008, we categorized 19% of our loans to homebuilders and 7% of our single-family mortgage loans as non-performing. As a result, we recorded \$99 million in provision for credit losses in second quarter 2008 and \$157 million for first six months 2008.

We expect these market conditions will continue throughout 2008.

Analysis of Second Quarter 2008 and 2007

Performance Ratios

| | Three Months Ended June | | Six Months Ended June | |
|---|-------------------------|-------|-----------------------|-------|
| | 2008 | 2007 | 2008 | 2007 |
| Return on assets (net (loss) income divided by average total assets) | (2.08)% | 0.61% | (1.16)% | 0.65% |
| Return on equity (net (loss) income divided by average stockholders equity) | (37.12)% | 9.38% | (18.43)% | 9.94% |
| Dividend payout ratio (dividends declared divided by net income) | | 146% | | 69% |
| Equity to asset ratio (average stockholders equity divided by average assets) | 5.60% | 6.48% | 6.28% | 6.52% |
| Net interest margin (net interest income divided by average earning assets) | 2.54% | 2.55% | 2.51% | 2.55% |

Significant aspects of our results of operations for second quarter 2008 follow:

Net loss was \$85 million, a decline of \$109 million from second quarter 2007, primarily a result of credit loss provisions and a deferred income tax asset valuation allowance.

Net interest income increased 5% compared to second quarter 2007. Net interest margin was approximately the same as second quarter 2007, with decreases in lower-margin single-family mortgage loans and mortgage-backed securities offsetting an increase in nonaccrual loans.

We recorded \$99 million in credit loss provisions compared to an insignificant net provision expense in second quarter 2007. Approximately half of the second quarter 2008 provision for credit loss related to homebuilder loans, with the majority of the remainder related to single-family mortgage loans and an energy loan.

We recorded a \$46 million valuation allowance against deferred tax assets, principally associated with allowances for credit losses, because of uncertainty regarding our ability to realize those assets.

We recorded \$3 million in severance costs related to a 135 person reduction-in-force.

Results of Operations*Net Interest Income*

Our net interest income increased because of an increase in earning assets, principally loans. Our commercial and business and commercial real estate portfolios continued to increase, while our single-family mortgage and homebuilder portfolios declined in balance. Additionally, in second quarter 2008, we recovered \$1 million in interest income on a mortgage-backed security which the trustee had previously misallocated to other security holders.

Our net interest margin of 2.54% in second quarter 2008 was essentially unchanged from 2.55% in second quarter 2007. Non-performing loans increased from \$29 million at June 30, 2007 to \$364 million at June 30, 2008. Interest income we would have recognized on nonaccrual loans, had they been performing in accordance with contractual terms, was \$6 million in second quarter 2008 and was not significant in second quarter 2007. However, the negative net interest margin effect of the increased non-performing loans was offset by improved margins on deposits as a result of declining market rates.

As we are currently positioned, if interest rates remain relatively stable, it is likely our net interest margin will remain near its current level. However, if interest rates decrease, our net interest margin is likely to decline. Please read **Item 3. Quantitative and Qualitative Disclosure about Market Risk** for further quantitative information about the sensitivity of our earnings to potential changes in interest rates.

Average balances, interest income and expense, and rates by major balance sheet categories were:

| | Three Months Ended June 30, | | | | | |
|---|------------------------------------|-----------------|------------------------|----------------------------|-----------------|------------------------|
| | 2008 | | | 2007 | | |
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| | (Dollars in millions) | | | | | |
| ASSETS | | | | | | |
| Cash equivalents | \$ 82 | \$ | 2.27% | \$ 79 | \$ 2 | 5.08% |
| Loans held for sale | 1 | | | 19 | | 7.31% |
| Loans | 10,332 | 131 | 5.09% | 9,573 | 175 | 7.32% |
| Securities | 5,187 | 69 | 5.26% | 5,024 | 67 | 5.31% |
| Investments in Federal Home Loan Bank stock | 259 | 2 | 3.07% | 208 | 3 | 5.61% |
| Total earning assets | 15,861 | \$ 202 | 5.10% | 14,903 | \$ 247 | 6.61% |
| Unrealized (losses) gains on available-for-sale securities | (405) | | | 1 | | |
| Other assets | 907 | | | 889 | | |
| Total assets | \$ 16,363 | | | \$ 15,793 | | |
| LIABILITIES AND EQUITY | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing demand | \$ 3,817 | \$ 18 | 1.88% | \$ 3,699 | \$ 26 | 2.81% |
| Savings deposits | 178 | 1 | 0.78% | 190 | 1 | 0.72% |
| Certificates of deposit | 4,410 | 41 | 3.75% | 4,888 | 59 | 4.87% |
| Total interest-bearing deposits | 8,405 | 60 | 2.84% | 8,777 | 86 | 3.91% |
| Short-term Federal Home Loan | | | | | | |
| Bank borrowings | 5,112 | 28 | 2.22% | 3,645 | 48 | 5.27% |
| | 735 | 8 | 4.27% | 934 | 8 | 3.51% |

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| | | | | | | |
|--|-----------|--------|-------|-----------|--------|-------|
| Long-term Federal Home Loan | | | | | | |
| Bank borrowings | | | | | | |
| Subordinated notes payable to trust | 314 | 4 | 4.54% | 315 | 5 | 7.04% |
| Subordinated debentures and other borrowings | 100 | 2 | 8.15% | 105 | 3 | 8.34% |
| Preferred stock issued by subsidiaries | | | | 74 | 2 | 8.01% |
| Total borrowings | 6,261 | 42 | 2.67% | 5,073 | 66 | 5.16% |
| Total interest-bearing liabilities | 14,666 | \$ 102 | 2.77% | 13,850 | \$ 152 | 4.37% |
| Interest rate spread | | | 2.33% | | | 2.24% |
| Noninterest-bearing demand deposits | | | | | | |
| | 641 | | | 703 | | |
| Other liabilities | | | | | | |
| | 140 | | | 217 | | |
| Stockholders equity | | | | | | |
| | 916 | | | 1,023 | | |
| Total liabilities and stockholders equity | \$ 16,363 | | | \$ 15,793 | | |
| Impact of noninterest-bearing funds | | | 0.21% | | | 0.31% |
| Net interest income/margin | | \$ 100 | 2.54% | | \$ 95 | 2.55% |

| | Six Months Ended June 30, | | | | | |
|---|---------------------------|----------|---|--------------------|----------|----------------|
| | 2008 | | | 2007 | | |
| | Average Balance | Interest | Yield/ Rate (Dollars in millions) | Average Balance | Interest | Yield/ Rate |
| ASSETS | | | | | | |
| Cash equivalents | \$ 73 | \$ | 2.74% | \$ 86 | \$ 2 | 5.06% |
| Loans held for sale | 5 | | 3.49% | 20 | | 7.47% |
| Loans | 10,147 | 282 | 5.56% | 9,514 | 346 | 7.27% |
| Securities | 5,306 | 143 | 5.38% | 5,062 | 135 | 5.32% |
| Investments in Federal Home Loan Bank stock | 255 | 5 | 3.66% | 217 | 7 | 5.94% |
| Total earning assets | 15,786 | \$ 430 | 5.45% | 14,899 | \$ 490 | 6.57% |
| Unrealized (losses) gains on available-for-sale securities | (231) | | | 1 | | |
| Other assets | 868 | | | 826 | | |
| Total assets | \$ 16,423 | | | \$ 15,726 | | |
| LIABILITIES AND EQUITY | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing demand | \$ 3,745 | \$ 40 | 2.15% | \$ 3,585 | \$ 49 | 2.75% |
| Savings deposits | 176 | 1 | 0.75% | 191 | 1 | 0.71% |
| Certificates of deposit | 4,575 | 95 | 4.16% | 4,928 | 119 | 4.83% |
| Total interest-bearing deposits | 8,496 | 136 | 3.20% | 8,704 | 169 | 3.88% |
| Short-term Federal Home Loan | | | | | | |
| Bank borrowings | 4,922 | 67 | 2.72% | 3,543 | 93 | 5.24% |
| Long-term Federal Home Loan | | | | | | |
| Bank borrowings | 757 | 16 | 4.23% | 1,015 | 18 | 3.56% |
| Subordinated notes payable to trust | 314 | 9 | 5.44% | 238 | 8 | 6.85% |
| Subordinated debentures and other borrowings | 104 | 4 | 8.32% | 106 | 5 | 8.23% |
| Preferred stock issued by subsidiaries | | | | 191 | 7 | 7.30% |
| Total borrowings | 6,097 | 96 | 3.14% | 5,093 | 131 | 5.12% |
| Total interest-bearing liabilities | 14,593 | \$ 232 | 3.18% | 13,797 | \$ 300 | 4.34% |
| Interest rate spread | | | 2.27% | 2.23% | | |
| Noninterest-bearing demand | | | | | | |
| deposits | 657 | | | 712 | | |
| Other liabilities | 142 | | | 191 | | |
| Stockholders equity | 1,031 | | | 1,026 | | |

| | | | | |
|---|-----------|-------|-----------|-------|
| Total liabilities and stockholders equity | \$ 16,423 | | \$ 15,726 | |
| Impact of noninterest-bearing funds | | 0.24% | | 0.32% |
| Net interest income/margin | \$ 198 | 2.51% | \$ 190 | 2.55% |

The majority of our earning assets are variable rate. Decreases in the rates earned on our assets in second quarter 2008 compared to second quarter 2007 are principally a result of decreases in short-term market interest rates. These market rate decreases also decreased the rates we paid on our deposit liabilities and borrowings.

Provision for Credit Losses

We recorded \$99 million in provision for credit losses in second quarter 2008 compared to an insignificant net provision expense in second quarter 2007. We recorded \$157 million in provision for credit losses in first six months 2008 compared to \$2 million credit provision in first six months 2007. Significant declines in the financial condition and liquidity of our homebuilder portfolio customers, as a result of current residential housing conditions, were the primary cause of our second quarter 2008 provision for credit losses. We recorded net charge-offs of \$19 million in second quarter 2008, principally related to foreclosed homebuilder loans. We anticipate it will become necessary for us to acquire the underlying collateral for a number of our loans to homebuilders during the remainder of 2008. It is likely we will record significant charge-offs and foreclosed real estate when we acquire collateral on those loans.

Please read **Credit Risk** for a discussion of our allowances for credit losses.

Noninterest Income

Noninterest income consists of:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--|-----------------------------|-------|---------------------|---------------------------|-------|---------------------|
| | 2008 | 2007 | Increase (Decrease) | 2008 | 2007 | Increase (Decrease) |
| | (Dollars in millions) | | | | | |
| Insurance commissions and fees | \$ 17 | \$ 16 | \$ 1 | \$ 36 | \$ 32 | \$ 4 |
| Service charges on deposits | 15 | 13 | 2 | 28 | 25 | 3 |
| Commercial loan facility fees | 3 | 4 | (1) | 7 | 10 | (3) |
| Operating lease income | 1 | 2 | (1) | 3 | 4 | (1) |
| Mutual fund and variable annuity sales commissions | 2 | 1 | 1 | 3 | 3 | |
| Other | 3 | 2 | 1 | 6 | 3 | 3 |
| | \$ 41 | \$ 38 | \$ 3 | \$ 83 | \$ 77 | \$ 6 |

Percent increase for the period 8% 8%

Insurance commissions and fees increased because of higher non-deposit investment product sales as a result of declining deposit rates.

Commercial loan facility fees consist of fees based on unfunded committed amounts, facility usage fees, letter of credit fees, and syndication agent fees. The decrease in commercial loan facility fees was principally a result of decreases in fees from homebuilders as a result of decreases in activity levels by those customers.

Noninterest Expense

Noninterest expense consists of:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--|-----------------------------|-------|---------------------|---------------------------|-------|---------------------|
| | 2008 | 2007 | Increase (Decrease) | 2008 | 2007 | Increase (Decrease) |
| | (Dollars in millions) | | | | | |
| Compensation and benefits | \$ 48 | \$ 43 | \$ 5 | \$ 99 | \$ 91 | \$ 8 |
| Occupancy | 9 | 7 | 2 | 17 | 13 | 4 |
| Information systems and technology | 4 | 4 | | 9 | 7 | 2 |
| Advertising and promotional | 4 | 3 | 1 | 11 | 7 | 4 |
| Furniture, fixtures, and equipment | 5 | 4 | 1 | 11 | 8 | 3 |
| Professional services | 5 | 2 | 3 | 8 | 4 | 4 |
| Travel and other employee costs | 4 | 3 | 1 | 6 | 5 | 1 |
| Postage, printing, and supplies | 2 | 2 | | 4 | 4 | |
| Litigation charge | | 5 | (5) | | 5 | (5) |
| Depreciation of assets leased to others | 2 | 1 | 1 | 3 | 3 | |
| Other | 13 | 13 | | 27 | 25 | 2 |
| Shared services allocation from Temple-Inland Inc. | | 7 | (7) | | 15 | (15) |
| | 96 | 94 | 2 | 195 | 187 | 8 |

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| | | | | |
|--|---|---|---|---|
| Charges related to asset impairments and severance | 3 | 3 | 3 | 3 |
|--|---|---|---|---|

| | | | | | | |
|--|-------|-------|------|--------|--------|-------|
| | \$ 99 | \$ 94 | \$ 5 | \$ 198 | \$ 187 | \$ 11 |
|--|-------|-------|------|--------|--------|-------|

| | | |
|---|----|----|
| Percent increase for the period, excluding charges related to asset impairments and severance | 2% | 4% |
|---|----|----|

Increases in many of our direct costs and expense categories in 2008 compared to 2007, particularly compensation and benefits, were because we began to perform many activities ourselves following our separation

from Temple-Inland Inc. Additionally, our marketing costs increased in second quarter 2008 as we implemented initiatives related to increasing consumer lending through our branch network and a new checking product.

We expensed \$3 million, and paid \$2 million, in severance in second quarter 2008 related to the reduction-in-force we announced during second quarter. We expect the reduction-in-force will save approximately \$10 million annually in compensation costs.

Income Tax Expense

Our effective tax rate was negative 49% in second quarter 2008 and 38% in second quarter 2007. In second quarter 2008, we established a valuation allowance against deferred tax assets of \$46 million. Excluding the valuation allowance, our effective tax rate in second quarter 2008 was 31%. The decrease in effective rate, excluding valuation allowance, in 2008 is a result of the impact of state margin taxes, particularly Texas, for which we do not receive a tax benefit from our net loss.

Segment Performance Summary

Segment operating income (loss), which we measure exclusive of taxes, consists of:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------|--|-------------|--------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In millions) | | | |
| Commercial banking | \$ (30) | \$ 58 | \$ (24) | \$ 121 |
| Retail banking | (17) | (8) | (37) | (15) |
| Insurance agency | 1 | 2 | 2 | 4 |
| Mortgage banking | (1) | (7) | (2) | (8) |
| Treasury, corporate and other | (10) | (6) | (13) | (20) |
| | \$ (57) | \$ 39 | \$ (74) | \$ 82 |

Commercial Banking

Second quarter 2008 segment operating results decreased \$88 million compared to second quarter 2007. The principal cause of the decrease was \$86 million in provision for credit losses on commercial loans in second quarter 2008. The provision for credit losses was predominantly related to increases in non-performing homebuilder loans, which increased from \$182 million at March 31, 2008 to \$233 million at June 30, 2008. Additionally, in second quarter 2008, we recorded a credit loss provision related to our portion of a syndicated loan to a diversified energy company that declared bankruptcy subsequent to the end of the quarter.

Retail Banking

Second quarter 2008 segment operating results decreased \$9 million compared to second quarter 2007. Segment net interest income decreased because earnings credits on deposits decreased as wholesale interest rates declined, but deposit pricing did not decrease proportionately with wholesale price declines. Retail banking noninterest expense increased \$2 million in second quarter 2008 compared to second quarter 2007 because of the increase in marketing costs, and because of operating expenses from branches opened since second quarter 2007.

Insurance Agency

In second quarter 2008, insurance agency commissions and fees increased \$1 million compared to second quarter 2007 because of increased non-deposit investment sales. However, segment noninterest expense increased \$2 million compared to second quarter 2007 because of costs associated with the non-deposit investment product sales and costs of the agency we acquired in 2007.

Treasury, corporate and other

Segment operating results in second quarter 2008 decreased \$4 million compared to second quarter 2007, principally because of provisions for credit losses not allocated to our other segments, severance costs related to a 135-person reduction-in-force, and share-based compensation related to director and employee awards granted in

2008. The residual impact of funds transfer pricing, during a period of varying interest rates, partially offset these reductions in segment operating results.

Financial Condition

Loans

The composition of our loans at June 30, 2008 follows:

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The loan portfolio consists of:

| | June 30, 2008 | | December 31, 2007 | |
|---|---------------|---|-------------------|------------------------|
| | Balance | Percent of Total Loans (Dollars in millions) | Balance | Percent of Total Loans |
| Single-family mortgage | \$ 1,485 | 14% | \$ 1,672 | 17% |
| Single-family mortgage warehouse | 971 | 9% | 695 | 7% |
| Single-family construction (homebuilders) | 1,223 | 12% | 1,510 | 15% |
| Multifamily and senior housing | 1,877 | 18% | 1,541 | 15% |
| Commercial real estate | 1,774 | 17% | 1,674 | 17% |
| Commercial and business | 1,384 | 14% | 1,340 | 13% |
| Energy | 1,334 | 13% | 1,470 | 15% |
| Consumer and other | 197 | 3% | 144 | 1% |
| Total loans | 10,245 | 100% | 10,046 | 100% |
| Less allowance for loan losses | (250) | | (118) | |
| Loans, net | \$ 9,995 | | \$ 9,928 | |

The single-family construction portfolio consists of loans to finance homebuilding activities, including construction and acquisition of developed lots and undeveloped land. Single-family construction loans decreased in 2008 because we have exited a number of credit relationships to reduce our risk. It is likely this trend will continue and also likely we will experience charge-offs and provide for credit losses throughout 2008 related to single-family construction loans. Please read **Credit Risk** for further information regarding credit risk characteristics of our single-family construction loan portfolio.

We did not acquire a significant volume of mortgage loans through our correspondent mortgage operations and have decided not to pursue this business. As a result, we expect our single-family mortgage loan portfolio will continue to decrease.

Commercial real estate and multifamily loans continue to increase as a result of further development and funding on loan commitments in those portfolios. We anticipate our commercial real estate loans outstanding will continue to increase for the remainder of 2008 as we fund draws on committed construction loans, partially offsetting decreases in single-family mortgage loans.

Information about our single-family mortgage loans, by category follows:

| | June 30, 2008 | | December 31, 2007 | |
|-------------------|--------------------------|--|--------------------------|-----------------------------|
| | Unpaid Principal Balance | Total Delinquency > 30 days (Dollars in millions) | Unpaid Principal Balance | Total Delinquency > 30 days |
| Option ARMs | \$ 407 | 21.04% | \$ 502 | 10.80% |
| Intermediate ARMs | 589 | 5.53% | 709 | 3.27% |
| Other first liens | 342 | 8.86% | 279 | 8.00% |
| Repurchased loans | 33 | 42.00% | 35 | 41.64% |
| Second liens | 114 | 1.86% | 147 | 1.54% |

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\$ 1,485 11.09% \$ 1,672 6.97%

Of the decrease in Option ARM loans in first six months 2008, \$56 million were customers who elected to convert to Intermediate ARMs at current market rates.

Investment Securities

The following charts summarize the fair value distribution of our mortgage-backed securities portfolio at June 30, 2008.

By Issuer

By Type

All of the mortgage-backed securities we own have single-family residential mortgage loans as the underlying assets. None of the securities include sub-prime loans. All of the non-agency securities are credit-enhanced by subordinate tranches not owned by us, that will absorb credit losses of the underlying loans until those tranches are depleted. At June 30, 2008, subordinated tranches averaged 16% of the outstanding balances of the loan pools underlying the securities, and on average 20% of the loans in the loan pools were delinquent on their payments.

The current environment in the housing and credit markets has resulted in significant devaluation of many securities backed by mortgage assets. At June 30, 2008, all of the non-agency securities we own carried AAA ratings from two different nationally recognized securities rating organizations. Subsequent to second quarter end, one rating organization downgraded one of the non-agency securities, which had an amortized cost of \$56 million at June 30, 2008, to single-A. Additionally, nine other non-agency securities, with a cumulative amortized cost of \$1.0 billion, have been designated as negative watch by one or both of those rating organizations. Though determination of fair value is currently difficult because of limited trading activity of these types of securities, information we gathered about market activity resulted in us concluding the fair value, as defined in SFAS No. 157, of the non-agency mortgage-backed securities was \$1.4 billion less than our amortized cost at June 30, 2008. We have recorded \$513 million of this unrealized loss in the carrying value of securities we classify as available-for-sale; the remainder relates to securities we classify as held-to-maturity and therefore we have not recorded those declines in the carrying value of the related securities. In second quarter 2008, we received \$234 million in principal paydowns on mortgage-backed securities.

Information about our valuation techniques, significant inputs to valuation models, and calibration of those models is included in Note 18 to our financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Based on our most recent analyses of delinquencies and subordinated tranches, we continue to believe we will receive all stated interest and principal on the non-agency securities. We do not have any plans to sell any of the securities and have the intent and ability to hold them until repayment; therefore we have not recorded any of the unrealized declines in value in our earnings. However, our consideration of whether the unrealized losses are other-than-temporary includes many factors including the length of time a security has had an unrealized loss, the severity of the unrealized loss and the ratings assigned by rating organizations. If the unrealized losses persist or further increase, the securities ratings were to be substantially downgraded, or our estimates of cash flows decrease, we might conclude some or all of the unrealized losses as a result of these conditions were other-than-temporary, which would result in a charge to earnings and a corresponding decrease in regulatory capital.

Information about our mortgage-backed securities portfolio at June 30, 2008 follows:

| | Amortized Cost | Net Unrealized Losses on Available-for- Sale Securities | Carrying Value (In millions) | Net Unrealized Losses on Held- to-Maturity Securities | Fair Value |
|---|---------------------------|--|---|--|-------------------|
| U.S. Government and U.S. Government Sponsored Enterprises | \$ 1,477 | \$ 1 | \$ 1,478 | \$ 4 | \$ 1,482 |
| Non-agency: Internally valued | 3,459 | (514) | 2,945 | (899) | 2,046 |
| Market quotes | 171 | | 171 | (3) | 168 |
| | \$ 5,107 | \$ (513) | \$ 4,594 | \$ (898) | \$ 3,696 |

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Information about our non-agency securities at June 30, 2008 follows:

| Issuer and Underlying Asset Type | Tranche | Cusip (Dollars in millions) | Delinquency % | | | Subord- ination % | Loan Originator | Unpaid Principa Balance | Carrying Value | Fair Value |
|---|-------------|--------------------------------|---------------|------------|-----|---|-----------------|-------------------------------|-------------------|---------------|
| | | | Total | >60 day | % | | | | | |
| 12MTA Option ARMs | | | | | | | | | | |
| Structured Asset Mortgage Investment II Trust 2007-AR6 | Class A2 | 86364RAB5 | 16% | 12% | 11% | American Home Mortgage Corp | \$ 412 | \$ 206 | \$ 206* | |
| RALI 2007-QO5 Trust | Class A | 74924AAA3 | 18% | 11% | 11% | Homecomings Financial | 206 | 140 | 140* | |
| Alternative Loan Trust 2005-81 | Class A-4 | 12668BBR3 | 26% | 21% | 13% | Countrywide Home Loans | 143 | 145 | 79 | |
| Structured Asset Mortgage Investment II Trust 2005-AR8 | Class A-5 | 86359LSB6 | 29% | 23% | 13% | Countrywide Home Loans | 136 | 137 | 68 | |
| Alternative Loan Trust 2006-OA2 | Class A-7 | 126694V88 | 35% | 29% | 16% | Countrywide Home Loans | 131 | 134 | 65 | |
| Alternative Loan Trust 2005-76 | Class 1-A-2 | 12668BDD2 | 32% | 27% | 17% | Countrywide Home Loans | 127 | 129 | 64 | |
| Alternative Loan Trust 2005-58 | Class A-3 | 12668AWK7 | 29% | 23% | 15% | Countrywide Home Loans | 123 | 125 | 72 | |
| Alternative Loan Trust 2005-51 | Class 3-A-1 | 12668ACW3 | 27% | 22% | 17% | Countrywide Home Loans | 126 | 127 | 60 | |
| Alternative Loan Trust 2005-62 | Class 1-A-2 | 12668ATP0 | 33% | 28% | 18% | Countrywide Home Loans | 118 | 119 | 79 | |
| RALI Series 2005-QO5 Trust | Class A-3 | 761118QP6 | 29% | 23% | 15% | Homecomings Financial Network, SCME, Mortgage IT, Other | 99 | 100 | 46 | |
| RALI Series 2005-Q01 Trust | Class A-4 | 761118ER5 | 21% | 15% | 17% | Homecomings Financial Network, Other | 90 | 92 | 53 | |
| Alternative Loan Trust 2005-38 | Class A-2 | 12667GZ22 | 27% | 23% | 19% | Countrywide Home Loans | 71 | 73 | 50 | |
| Alternative Loan Trust 2005-41 | Class 2-A-1 | 12667GR96 | 27% | 21% | 21% | Countrywide Home Loans | 68 | 69 | 38 | |
| Structured Asset Mortgage Investments II Trust 2006-AR3 | Class 12A4 | 86360KAH1 | 33% | 27% | 14% | Countrywide Home Loans, Bank of America, and other | 70 | 71 | 44 | |
| Harborview Mortgage Loan Trust 2005-8 | Class 2A3 | 41161PRT2 | 22% | 19% | 20% | Countrywide Home Loans | 61 | 63 | 39 | |
| Greenpoint Mortgage Funding Trust 2005-AR5 | Class I-A-2 | 39538WEC8 | 37% | 30% | 22% | Greenpoint Mortgage Funding | 54 | 56 | 35 | |
| Structured Asset Mortgage Investments II Trust 2005-AR4 | Class A2 | 86359LMA4 | 31% | 26% | 23% | Countrywide Home Loans | 55 | 57 | 33 | |

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| | | | | | | | | | |
|--|------------|-----------|-----|-----|-----|--|-------|-------|-------|
| WaMu Mortgage Pass-Through Certificates, Series 2005-AR9 | Class A2A | 92922FU97 | 8% | 6% | 19% | One or more approved institutions | 51 | 52 | 30 |
| Structured Asset Mortgage Investments II Trust 2005-AR7 | Class 5A2 | 86359LQT9 | 22% | 18% | 18% | Southstar Funding LLC/Opteum Financial Services LLC, First Horizon, BOA, other | 41 | 41 | 19 |
| Greenpoint Mortgage Funding Trust 2006-AR3 | Class 4A3 | 39538WHH4 | 28% | 23% | 15% | Greenpoint Mortgage Funding | 38 | 39 | 26 |
| Harborview Mortgage Loan Trust 2005-16 | Class 4A1B | 41161PZD8 | 25% | 22% | 20% | Countrywide Home Loans | 32 | 32 | 19 |
| IndyMac INDX Mortgage Loan Trust 2005-16IP | Class A3 | 45660LUF4 | 20% | 16% | 20% | IndyMac Bank, F.S.B. | 27 | 28 | 18 |
| | | | | | | | 2,279 | 2,035 | 1,283 |

* Security designated as available-for-sale

| Issuer and Underlying Asset Type | Tranche | Cusip (Dollars in millions) | Delinquency | | Subord- ination % | Loan Originator | Unpaid | | Fair Value |
|---|-------------|--------------------------------|-------------|------------|-------------------------|--|---------------------|-------------------|---------------|
| | | | Total | >60 day | | | Principa Balance | Carrying Value | |
| Hybrid Option ARMs (5Y Fixed/12MTA) | | | | | | | | | |
| RALI 2007-QH8 Trust | Class A | 74924EAA5 | 15% | 10% | 12% | Homecomings Financial | 482 | 313 | 313* |
| COFI Option ARMs | | | | | | | | | |
| WaMu Mortgage Pass-Through Certificates 2007-OA4 | Class 2A | 93364CAC2 | 14% | 10% | 30% | Washington Mutual Bank | 135 | 94 | 94* |
| Washington Mutual Mortgage Pass-Through Certificates WMALT 2007-OA3 Trust | Class 5A | 939355AE3 | 19% | 14% | 14% | Washington Mutual Bank or others, Mortgage IT | 120 | 120 | 87 |
| WaMu Mortgage Pass-Through Certificates 2007-OA5 | Class 2A | 93364BAC4 | 14% | 11% | 30% | Washington Mutual Bank | 107 | 75 | 75* |
| WaMu Mortgage Pass- Through Certificates 2006-AR9 | Class 2A-1B | 93363DAC1 | 8% | 6% | 10% | Washington Mutual Bank | 85 | 84 | 51 |
| WaMu Mortgage Pass -Through Certificates 2006-AR9 | Class 2A | 93363DAB3 | 8% | 6% | 36% | Washington Mutual Bank | 53 | 53 | 37 |
| WaMu Mortgage Pass- Through Certificates 2006-AR11 | Class 2A-1B | 93363TAC6 | 11% | 8% | 10% | Washington Mutual Bank | 42 | 43 | 26 |
| WaMu Mortgage Pass Through Certificates 2006-AR13 | Class 2A-1B | 93363RAC0 | 11% | 7% | 10% | Washington Mutual Bank | 37 | 37 | 25 |
| WaMu Mortgage Pass- Through Certificates 2006-AR15 | Class 2A-1B | 93363QAD0 | 10% | 8% | 10% | Washington Mutual Bank | 31 | 31 | 19 |
| WaMu Mortgage Pass- Through Certificates 2006-AR17 | Class 2A-1B | 92925DAE0 | 10% | 7% | 10% | Washington Mutual Bank | 24 | 24 | 15 |
| WaMu Mortgage Pass- Through Certificates 2006-AR19 | Class 2A | 933638AD0 | 10% | 9% | 39% | Washington Mutual Bank | 20 | 20 | 14 |
| WaMu Mortgage Pass- Through Certificates 2006-AR19 | Class 2A-1B | 933638AE8 | 10% | 9% | 9% | Washington Mutual Bank | 13 | 13 | 8 |
| Home Savings of America 1988-7A | | 436904AG1 | | | 103% | Not Available | 1 | 1 | 1* |
| Home Savings of America 1988-8A | | 436904AJ5 | | | 99% | Not Available | 2 | 2 | 2* |
| Home Savings of America 1988-10A | | 436904AK2 | | | 102% | Not Available | 1 | 1 | 1* |
| Home Savings of America 1988-11A | | 436904AL0 | | | 102% | Not Available | 1 | 1 | 1* |
| | | | | | | | 672 | 599 | 456 |
| 5/1 LIBOR | | | | | | | | | |
| | Class 2A1 | 05949ARD4 | 3% | 2% | 7% | | 40 | 40 | 38 |

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| | | | | | | | | | |
|---|-----------|-----------|-----|-----|-----|-----------------------|---------|---------|---------|
| Banc of America Mortgage Securities, Inc. | | | | | | Bank of America, N.A. | | | |
| Mortgage Pass-Through Certificates, Series 2004-H | | | | | | | | | |
| GSR Mortgage Loan Trust 2004-11 | Class 2A1 | 36242DFS7 | 4% | 3% | 9% | Various Lenders | 42 | 43 | 41 |
| Banc of America Mortgage Securities, Inc. | | | | | | | | | |
| Mortgage Pass-Through Certificates, Series 2003-K | Class 2A2 | 05948XZH7 | 1% | 1% | 6% | Bank of America, N.A. | 33 | 33 | 32 |
| Banc of America Mortgage Securities, Inc. | | | | | | | | | |
| Mortgage Pass-Through Certificates, Series 2003-H | Class 2A2 | 05948XTH4 | 1% | 1% | 6% | Bank of America, N.A. | 25 | 26 | 24 |
| GSR Mortgage Loan Trust 2003-9 | Class A2 | 36228FWS1 | 2% | 2% | 8% | Various Lenders | 18 | 18 | 18 |
| Banc of America Mortgage Securities, Inc. | | | | | | | | | |
| Mortgage Pass-Through Certificates, Series 2003-D | Class 2A3 | 05948XBU4 | 3% | 2% | 7% | Bank of America, N.A. | 7 | 7 | 7 |
| Banc of America Mortgage Securities, Inc. | | | | | | | | | |
| Mortgage Pass-Through Certificates, Series 2003-A | Class 2A1 | 05948LAE7 | 5% | 2% | 8% | Bank of America, N.A. | 2 | 2 | 2 |
| | | | | | | | 167 | 169 | 162 |
| | | | 20% | 16% | 16% | | \$3,600 | \$3,116 | \$2,214 |

* Security designated as available-for-sale

Information at June 30, 2008 about the geographic distribution of the mortgage loans underlying the non-agency securities we own follows:

| | |
|---------------|------|
| California | 60% |
| Florida | 12% |
| Arizona | 3% |
| Other | 8% |
| Not available | 17% |
| | 100% |

Deposits

Deposits consist of:

June 30, 2008

December 31, 2007

Included in transaction accounts are interest-bearing checking accounts totaling \$1.1 billion at June 30, 2008 and \$1.2 billion at June 30, 2007. We recorded interest expense on interest-bearing checking accounts at an average rate of 0.4% for second quarter 2008 and 0.5% for second quarter 2007. Total deposits decreased by 2% at June 30, 2008 compared to December 31, 2007.

Borrowings

Our FHLB borrowings consist of both short-term and long-term borrowings. Short-term borrowings are generally 7 to 30 days in maturity, and we use them to meet daily liquidity needs. We utilize longer-term FHLB borrowings at times to match the interest rate characteristics of some of our assets, such as those repricing after three to five years. Please read **Liquidity, Capital Resources, Off-Balance Sheet Arrangements, and Contractual Obligations** for information about collateral we have pledged for FHLB borrowings.

Credit Risk*Asset Quality and Allowance for Credit Losses*

Various asset quality measures we monitor are:

| | June 30, 2008 | December 31, 2007 |
|---|------------------------------|----------------------------------|
| | (Dollars in millions) | |
| Non-performing loans | \$ 364 | \$ 166 |
| Foreclosed real estate | 42 | 13 |
| Non-performing assets | \$ 406 | \$ 179 |
| Non-performing loans as a percentage of total loans | 3.55% | 1.65% |
| Non-performing assets divided by total loans and foreclosed real estate | 3.95% | 1.78% |
| Allowance for loan losses as a percentage of non-performing loans | 69% | 71% |
| Allowance for loan losses as a percentage of total loans | 2.44% | 1.17% |
| Single-family mortgage loan delinquencies as a percentage of single-family mortgage loans | 11.09% | 6.97% |

Information about our allowances for credit losses and nonaccrual and other loans follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in millions) | | | |

Conditions in the residential housing and credit markets continue to deteriorate. Our non-performing loans to homebuilders increased \$51 million in second quarter 2008. Our non-performing single-family mortgage loans also increased in second quarter 2008 by \$28 million. As a result, our asset quality measures have deteriorated substantially, including an increase in non-performing assets and much higher provisions for credit losses than over the previous several years. Until conditions in the housing and credit markets improve, it is likely we will continue to report significant non-performing assets, charge-offs, and provisions for credit losses.

The allowance for loan losses by loan category was:

| | June 30, 2008 | | December 31, 2007 | |
|---|---------------|---|-------------------|--|
| | Allowance | Allowance as a % of Loan Category (Dollars in millions) | Allowance | Allowance as a % of Loan Category |
| Single-family mortgage | \$ 24 | 1.62% | \$ 9 | 0.54% |
| Single-family mortgage warehouse | 5 | 0.51% | 6 | 0.86% |
| Single-family construction (homebuilders) | 136 | 11.12% | 48 | 3.18% |
| Multifamily and senior housing | 9 | 0.48% | 6 | 0.39% |
| Commercial real estate | 6 | 0.34% | 6 | 0.36% |
| Commercial and business | 22 | 1.59% | 15 | 1.12% |
| Energy | 19 | 1.42% | 6 | 0.41% |
| Consumer and other | 1 | 0.51% | | |
| Incurred but not yet identified losses | 28 | | 22 | |
| | \$ 250 | 2.44% | \$ 118 | 1.17% |

Concentration

Information about the underlying collateral and geographic location of our single-family construction loans, including local, regional, and national homebuilders at June 30, 2008 follows:

| | Lots and Land Acquisition and Single-Family Houses | | | | Total |
|------------|--|-------------|--------------------|---------------|-------|
| | Houses | Development | Other | (In millions) | |
| California | \$ 120 | \$ 250 | \$ 48 | \$ 418 | |
| Texas | 91 | 24 | | 115 | |
| Florida | 46 | 41 | 1 | 88 | |
| Arizona | 17 | 28 | 38 | 83 | |
| Colorado | 47 | 28 | | 75 | |
| Other | 121 | 164 | 159 ^(a) | 444 | |
| | \$ 442 | \$ 535 | \$ 246 | \$ 1,223 | |

(a) Principally unsecured loans to national homebuilders

Our commercial real estate construction loans are diversified geographically, and across a number of different property types. Information about those loans at June 30, 2008 follows:

% of % of

| | Commercial Real Estate | Total Loan Portfolio |
|------------|-----------------------------------|-------------------------------------|
| Office | 47% | 8% |
| Retail | 27% | 5% |
| Industrial | 14% | 2% |
| Land | 12% | 2% |
| | 100% | 17% |

We originate and maintain large credit relationships with a number of customers in the ordinary course of business as a result of the types of lending in which we engage. At June 30, 2008, we had 8 customers for which we had loan commitments exceeding \$100 million. Information about these relationships follows:

| | |
|-------------------------------|---|
| | Distribution of Credit Relationships Exceeding \$100 Million |
| Commitment Outstanding | |
| | (Dollars in millions) |

Liquidity, Capital Resources, Off-Balance Sheet Arrangements, and Contractual Obligations

Our principal operating cash requirements are for interest, compensation, and taxes. Changes in loans held for sale are subject to the timing of the origination and subsequent sale of the loans and the level of refinancing activity.

The change in our borrowings generally moves in tandem with the amounts invested in loans and securities less changes in deposits because we use borrowings to fund our investments in excess of deposits. The amount of borrowing will decrease as opportunity to invest decreases and will increase as opportunity to invest increases. In first six months 2008, we used cash flow from operations and principal payments on securities to fund increases in loans and decreases in deposits and borrowings.

Our liquidity needs are associated with cash flow requirements of our deposit and loan customers, our other commitments (including borrowing costs and maturities), and our operating activities. We have a variety of liquidity sources including:

Operating cash flows;

New deposits;

Ability to borrow from the FHLB; and

A portfolio of assets, including marketable mortgage-backed securities, which we can pledge as borrowings or sell or securitize if necessary.

Our borrowings from the FHLB are secured by a blanket floating lien on certain of our loans, and by securities we maintain on deposit at the FHLB. At June 30, 2008, \$11 billion in principal balance of our loans and securities were pledged as collateral for FHLB borrowings. Based upon this collateral, we have the ability to borrow an additional \$1.6 billion from the FHLB. Additionally, we have other assets not pledged as collateral on FHLB borrowings, which we could pledge as collateral with the FHLB or other lenders, including the Federal Reserve, and unsecured borrowing capacity, which provide an additional \$2.6 billion in available liquidity.

We continue to have sufficient liquidity resources, principally borrowing capacity at the Federal Home Loan Bank of Dallas (FHLB Dallas), to meet our anticipated loan funding and operating requirements. FHLB Dallas currently limits our ability to pledge non-agency mortgage-backed securities as collateral against our borrowings from them to securities rated BBB or higher. If a security becomes rated below AA, FHLB Dallas will reduce the available borrowing capacity by 5% for each grade lower than AA. If FHLB were to reduce our borrowing capacity because of further market value changes or any downgrades of our collateral, and we were not able to replace the financing on similar terms or replace the downgraded securities with other eligible collateral, our liquidity could be materially adversely affected. It would likely be difficult to secure replacement financing in the current credit markets.

Approximately \$1.9 billion (21%) of our deposits at June 30, 2008 were above the federal deposit insurance limits, of which \$1.6 billion were transaction accounts and \$300 million were certificates of deposit. Though we have not experienced any significant decreases, some institutions have recently experienced customers withdrawing uninsured deposits as a result of publicity surrounding recent insured depository institution failures. If we were to experience significant deposit withdrawals, we would need to replace the funding through further utilization of our FHLB borrowing capacity or other borrowing resources.

Contractual Obligations

At June 30, 2008 our contractual obligations consist of:

| | Total | Payments Due or Expiring by Period | | | | Indeterminable |
|--|-----------|------------------------------------|----------|---------|------------|----------------|
| | | 2008 | 2009-10 | 2011-12 | Thereafter | |
| (In millions) | | | | | | |
| Items on our balance sheet: | | | | | | |
| Transaction and savings deposit accounts | \$ 4,803 | \$ | \$ | \$ | \$ | \$ 4,803 |
| Certificates of deposit | 4,357 | 2,681 | 1,557 | 105 | 14 | |
| Federal Home Loan Bank borrowings | 5,553 | 5,119 | 309 | 125 | | |
| Subordinated notes payable to trust | 314 | | | | 314 | |
| Items not on our balance sheet: | | | | | | |
| Contractual interest payments | 548 | 49 | 103 | 51 | 345 | |
| Operating leases | 44 | 4 | 16 | 14 | 10 | |
| Processing contracts | 17 | 6 | 9 | 2 | | |
| | \$ 15,636 | \$ 7,859 | \$ 1,994 | \$ 297 | \$ 683 | \$ 4,803 |

Off-Balance Sheet Arrangements

In the normal course of business, we enter into off-balance sheet arrangements, such as commitments to extend credit for loans, leases, and letters of credit. Since many commercial and business loan commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Additionally, we generally require collateral upon funding of loan commitments, and once funded, they generally increase our borrowing capacity (referred to as *pledgeable* below). Our off-balance sheet unfunded credit arrangements consist of:

| | June 30, 2008 | December 31, 2007 |
|--|------------------|----------------------|
| (In millions) | | |
| Single-family mortgage loans | \$ 107 | \$ 87 |
| Unused lines of credit | 1,854 | 1,959 |
| Unfunded portion of credit commitments <i>pledgeable</i> | 2,876 | 3,866 |
| Unfunded portion of credit commitments <i>non-pledgeable</i> | 941 | 621 |
| Commitments to originate loans <i>pledgeable</i> | 95 | 337 |
| Commitments to originate loans <i>non-pledgeable</i> | 185 | 417 |
| Letters of credit | 338 | 359 |
| | \$ 6,396 | \$ 7,646 |

Capital Management

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In May 2008, we completed a private placement transaction, raising \$38 million. In July 2008, we completed a series of private placement transactions, raising \$562 million before offering costs. Substantially all of the proceeds will qualify as regulatory capital for Guaranty Bank. Including the proceeds from these transactions, our proforma regulatory capital ratios at June 30, 2008 would have been approximately 9.49% Tier 1 (Core) Leverage ratio and 14.62% Total Risk-Based ratio.

At June 30, 2008, Guaranty Bank was well-capitalized under the federal capital adequacy regulations. The following table sets forth actual capital amounts and ratios for Guaranty Bank, along with the minimum capital amounts

and ratios required of all federally insured financial institutions in order to meet capital adequacy requirements and to be categorized as well-capitalized .

| | Actual | | For Categorization as Well Capitalized | | Regulatory Minimum | |
|---|---------|--------|--|---------|--------------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Risk-Based Ratio (Risk-based Capital/Total Risk-weighted Assets) | \$1,391 | 10.60% | \$1,311 | ≥10.00% | \$1,049 | 8.00% |
| Tier 1 (Core) Risk-based Ratio (Core Capital/Total Risk-weighted Assets) | \$1,228 | 9.36% | \$ 787 | ≥ 6.00% | \$ 525 | 4.00% |
| Tier 1 (Core) Leverage Ratio (Core Capital/Adjusted Tangible Assets) | \$1,228 | 7.63% | \$ 805 | ≥ 5.00% | \$ 644 | 4.00% |
| Tangible Ratio (Tangible Capital/Tangible Assets) | \$1,228 | 7.63% | n/a | n/a | \$ 322 | 2.00% |

We did not pay or declare a dividend on our common stock in second quarter 2008. Our ability to pay dividends, which is limited by regulatory capital requirements at Guaranty Bank, has historically depended to a great extent on our after-tax earnings and our asset growth.

Recent Accounting Standards

Please see **Note 1 to our unaudited financial statements in Item 1** for information about new and pending accounting pronouncements.

Effects of Inflation

Inflation has had minimal effect on our operating results the past three years because substantially all of our assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our results than general levels of inflation.

Litigation Matters

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business and believe we have established adequate reserves for any probable losses. We do not believe the outcome of any of these proceedings should have a significant adverse effect on our financial position, long-term results of operations, or cash flow. It is possible, however, charges related to these matters could be significant to our results or cash flow in any one period.

A class action in California, related to our former mortgage banking operations, was dismissed but remains under appeal by the plaintiff. We have established reserves we believe are adequate for this matter, and do not anticipate the outcome will have a significant adverse effect on our financial position or results of operations or cash flow.

As a result of our participation in the Visa USA (Visa) network, principally related to ATM and debit cards, we own 33 thousand Class B common shares of Visa for which we have no carrying value. As a former member of Visa, we participate in an indemnification provision in Visa s bylaws. We are not a named defendant in any of Visa s litigation matters, and have no access to any non-public information about the matters.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

The following table illustrates the estimated effect on our pre-tax income of hypothetical immediate, parallel, and sustained shifts in interest rates for the next 12 months at June 30, 2008, compared to information at December 31, 2007. This estimate considers the effect of changing prepayment speeds, repricing characteristics, and expected average balances over the next 12 months.

| Change in Interest Rate | Increase (Decrease) in Income Before Taxes | |
|----------------------------|---|-------------------------|
| | June 30, 2008 | December 31, 2007 |
| | (In millions) | |
| +1% | \$ 14 | \$ (6) |
| -1% | (17) | (12) |

The change in our interest rate sensitivity from December 31, 2007 is principally because of the decrease in single-family mortgage loans and mortgage-backed securities. These assets have interest rates which are less responsive to changes in interest rates than our commercial loans. As the mortgage portfolios decrease, our overall asset yields become more responsive to changes in interest rates.

Additionally, our funding costs are less sensitive to changes in interest rates at June 30, 2008 because of two factors:

- the average time to maturity of our certificates of deposit lengthened during the first half of the year, delaying the responsiveness of the costs of those deposits to market rate changes; and,
- we expect the interest rates on our money market and checking account deposit liabilities will be less responsive to changes in interest rates because of the current low level of interest rates.

Reporting the effect of immediate and parallel rate changes is common industry practice; however, such changes are unlikely to occur. More typically, rates increase gradually, change in different amounts across the term structure, and change differently across products.

While the analysis strives to model accurately the hypothetical relationships being tested, there are numerous assumptions and estimates associated with these simulations which may not reflect the manner in which actual yields and costs respond to changes in market interest rates. Assumptions about interest rate changes, balance sheet growth, depositor behavior, or prepayment rates are by nature highly subjective, involve uncertainty and, therefore, are only estimates.

Foreign Currency Risk

We have no exposure to foreign currency fluctuations.

Commodity Price Risk

We have no direct exposure to commodity price fluctuations.

Item 4T. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing, and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in internal control over financial reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Since we filed our Annual Report on Form 10-K for the year ended December 31, 2007, there have been no material developments in pending legal proceedings.

We do not expect the eventual outcome of any or all of our pending legal matters would have a significant adverse effect on our financial position, long-term results of operations, or cash flow. It is possible that charges related to these matters could be significant to the results of operations or cash flows in any one accounting period.

Item 1A. Risk Factors

There are no material changes from the risk factors as previously disclosed in our Annual Report on Form 10-K for 2007, except as set forth below:

Volatility in the credit and residential housing markets could result in further losses on our mortgage-backed securities and loans.

Credit markets in many sectors have experienced dramatic reductions in liquidity and increases in required returns by investors in credit-sensitive assets. These conditions began in 2007 in the sub-prime mortgage market but have expanded in 2008 to include virtually all non-agency mortgage-backed securities and many other asset-backed markets. Mortgage-backed securities comprise a higher percentage of our assets than they do for many other financial institutions. At June 30, 2008, approximately 29% of our assets were mortgage-backed securities and approximately two-thirds of those securities were non-agency securities. Recent transactions by distressed sellers, and expectations of further distressed sales, have exacerbated market discounts for mortgage-backed securities and generally removed the majority of typical participants from transactions in non-agency securities. As a result, it is difficult to determine fair values for those securities and would likely be difficult to sell securities in the current market at all. We estimate the fair value of the non-agency securities we own was below amortized cost by approximately \$1.4 billion, or 39%, at June 30, 2008. Though we currently have the intent and ability to hold the securities until repayment, if it became necessary for us to sell non-agency securities, any sales would almost certainly be at a significant discount to par value which would have a negative effect on our operating results and capital position.

Current market conditions include a severe over-supply of land, lots, and finished homes in many markets including those where we do business. At June 30, 2008, approximately 8% of our assets were loans to homebuilders and 9% of our assets were single-family mortgage loans. Many of our homebuilder borrowers are experiencing decreased sales and pricing and some are facing significant financial difficulty. We had approximately \$233 million in non-performing homebuilder loans and approximately \$97 million of non-performing single-family mortgage loans at June 30, 2008. The percentage of our single-family mortgage loans delinquent in their payments has increased from 7% to 11% since year-end 2007. If housing markets, particularly in California, continue to deteriorate, we will experience a further increase in non-performing loans, provisions for loan losses, and charge-offs. While it is difficult to predict how long these conditions will exist and which markets, products or other segments of our loan and securities portfolio might ultimately be affected, these factors could adversely affect our ability to grow earning assets, return to profitability, or meet our financial obligations.

Declining real estate values may cause borrowers to default on loans underlying mortgage-backed securities we own, reducing the likelihood of recoverability of our investments.

Deterioration in the value of single-family homes may cause borrowers to default on the mortgages underlying the mortgage-backed securities we own. In the cash flow distribution from the underlying assets, our securities are generally senior to subordinated tranches intended to incur credit losses from the underlying loans before losses are allocated to our securities. However, if credit losses on the underlying loans were to exceed the subordinated tranches, we would not receive the full stated interest due on the securities or our full principal balance, or both. If we were to conclude unrealized losses on the mortgage-backed securities were other than temporary which we

evaluate by considering estimates of recoverability, as well as the duration and severity of the unrealized loss we would be required under generally accepted accounting principles to reduce the cost basis of the security to fair value and record a corresponding charge to earnings, which would also reduce our regulatory capital.

Many of the loans underlying the non-agency mortgage-backed securities we own have one or more characteristics increasing the risk of default by the borrowers. These characteristics include various monthly payment options, referred to as Option ARMs, and limited underwriting documentation. At June 30, 2008, over 95% of the loans underlying the non-agency mortgage-backed securities we own are Option ARMs. Additionally, approximately 60% of the loans underlying the non-agency mortgage-backed securities we own are secured by real estate in California.

If a significant portion of our non-agency mortgage-backed securities portfolio were to be downgraded below investment grade, or the market value of those securities further declined, it would negatively affect our liquidity.

At June 30, 2008, we had outstanding indebtedness to FHLB Dallas in the amount of \$5.6 billion. FHLB Dallas currently limits our ability to pledge non-agency mortgage-backed securities as collateral against our borrowings from them to securities rated BBB or higher. If a security becomes rated below AA, FHLB Dallas will reduce the available borrowing capacity by 5% for each grade lower than AA.

If FHLB were to reduce our borrowing capacity because of further market value changes or any downgrades of our collateral, and we were not able to replace the financing on similar terms or replace the downgraded securities with other eligible collateral, our liquidity could be materially and adversely affected. It may be difficult to secure replacement financing in the current credit markets.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

Guaranty's Annual Meeting of Stockholders was held on May 27, 2008 at 1300 South MoPac Expressway, Austin, Texas. A total of 33,211,390 of the Company's shares were present or represented by proxy at the meeting. This represented 89.18 percent of the Company's shares entitled to vote.

The matters approved by the stockholders at the meeting and the number of votes cast for, against, or withheld (as well as the number of abstentions and broker non-votes) as to each matter are set forth below:

Proposal No. 1: Election of Directors:

| Election of directors to three year terms, expiring 2011 | For | Against | Withheld |
|---|------------|----------------|-----------------|
| David W. Biegler | 28,701,406 | 1,723,769 | 2,786,215 |
| Leigh M. McAlister | 26,869,720 | 3,558,083 | 2,783,587 |
| Edward R. McPherson | 30,050,444 | 375,798 | 2,785,148 |
| Raul R. Romero | 26,957,444 | 3,469,458 | 2,784,488 |
| Bill D. Walker | 26,982,086 | 3,446,050 | 2,783,254 |

In addition, the following directors' terms of office continued after the Annual Meeting of Stockholders:

Kenneth R. Dubuque,

Kenneth M. Jastrow, II,

Larry R. Faulkner,

Robert V. Kavanaugh,

Robert D. McTeer,

John T. Stuart, and

Larry E. Temple.

Robert B. Rowling was appointed as director after the Annual Meeting of Stockholders during the second quarter of 2008.

Proposal No. 2: Ratification of Ernst & Young LLP as Independent Registered Public Accounting Firm for 2008:

| For | Against | Abstain | Non-Votes |
|------------|----------------|----------------|------------------|
| 30,316,692 | 120,090 | 2,774,608 | |

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit Number | Exhibit Description |
|-----------------------|---|
| 3.1 | Certificate of Designations, Preferences and Rights of Series B Mandatory Convertible Perpetual Cumulative Preferred Stock (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K as filed with the Commission on July 11, 2008) |
| 4.1 | Form of Subordinated Note (incorporated herein by reference to Exhibit 4.1 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.1 | Investment Agreement, dated May 26, 2008, between the Company and TRT Financial Holdings, LLC (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K as filed with the Commission on May 27, 2008) |
| 10.2 | First Amendment to Investment Agreement, dated May 29, 2008, between the Company, the Investor and the Investor Affiliates (incorporated by reference to Exhibit 10.18 to Amendment No. 4 to the Company's Registration Statement on Form S-1 as filed with the Commission on May 30, 2008) |
| 10.3 | Investment Agreement dated June 7, 2008 by and between the Company and TRT Financial Holdings, LLC (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.4 | Investment Agreement dated June 7, 2008 by and between the Company and Icahn Partners, LP (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.5 | Form of Investment Agreement entered into by the Company and investors other than Icahn Partners and TRT (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.6 | Purchase Agreement dated June 7, 2008 by and among the Company and the purchasers named therein (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.7 | Letter Agreement dated June 7, 2008 by and between the Company and Icahn Partners, LP (incorporated herein by reference to Exhibit 10.5 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |

| Exhibit Number | Exhibit Description |
|-----------------------|--|
| 10.8 | Letter Agreement dated June 7, 2008 by and between the Company and TRT Financial Holdings, LLC (incorporated herein by reference to Exhibit 10.6 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 10.9 | Agency Agreement between the Company, Guaranty Bank and Keefe, Bruyette & Woods, Inc. (incorporated herein by reference to Exhibit 10.7 to the Company's Form 8-K as filed with the Commission on June 9, 2008) |
| 31.1 | Certification of Kenneth R. Dubuque pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended |
| 31.2 | Certification of Ronald D. Murff pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended |
| 32.1 | Certification of Kenneth R. Dubuque pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Ronald D. Murff pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Guaranty Financial Group Inc.
(Registrant)

By: /s/ Craig E. Gifford
*Executive Vice President and
Principal Accounting Officer*

Date: August 11, 2008