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)

þ 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

o 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	**74-2421034**
(State or other jurisdiction of incorporation or organization)	(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 þ No o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes þ 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

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 June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 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	100	95	198	190
(Provision) credit for credit losses	(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	(57)	39	(74)	82
Income tax expense	(28)	(15)	(21)	(31)

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	

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	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net	Total Stockholders Equity
			(In millions)			
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, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 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

8

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	Balance	Weighted Average Interest Rate
	(Dollars in millions)			
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,		Six Months Ended June 30,	
	2008	2007	2008	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,		Six Months Ended June 30,	
	2008	2007	2008	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

(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 30,		Six Months Ended June 30,	
	2008	2007	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

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 Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 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	Total
		(In millions)	
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 30,		Six Months Ended June 30,	
	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%

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	Average Balance	Interest	Yield/ Rate
	(Dollars in millions)					
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

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:

The loan portfolio consists of:

	June 30, 2008		December 31, 2007	
	Balance	Percent of Total Loans	Balance	Percent of Total Loans
	(Dollars in millions)			
Single-family mortgage	$ 1,485	14%	$ 1,672	17%
Single-family mortgage warehouse	971	9%	695	7%
Singe-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