



Allegiance Bank<sup>SM</sup>

**A N N U A L R E P O R T 2 0 0 8**

## President's Letter

Dear Fellow Shareholders, Customers and Friends of Allegiance Bank:

I would like to first thank all of you for your support during the past year. We began 2008 with the optimism of establishing strategies to enhance our core banking business and to structure our balance sheet to deliver strong results for our shareholders. Our focus for 2008 shifted as the effects of the economic crises continued to impact the performance of our loan portfolio.

The strategies we used to enhance our core banking business during 2008 included restructuring our branch organization and sales strategy, and adding Market Development Officers to introduce new business customers to Allegiance Bank. These initiatives provided a nine percent increase in customer households during the fourth quarter and an overall twenty percent increase in deposits during the year. We also laid the groundwork for the launch of "My Allegiance Bank" ([www.MyAllegianceBank.com](http://www.MyAllegianceBank.com)) during the first quarter of 2009. My Allegiance Bank provides customers with access to our internet banking branch.

The effort to build our core banking business was impacted by the challenge of managing the increase in non-performing loans during 2008. The consolidated loan portfolio experienced an increase in impaired loans within both the bank and Paramount Mortgage and Capital, LLC (Paramount) portfolios. This increase in impaired loans impacted earnings through a reduction in net interest income, additional provisions for loan losses and increases in expenses to manage the impaired loans including legal and insurance costs. Management made the decision to shut down Paramount operations on February 29, 2008, due to a rise in delinquencies. Paramount provided short-term to moderate-term loans primarily to small real estate investors and developers. As a result of market conditions experienced during the past year, Paramount customers could not sell or refinance their properties and have seen market values drop below outstanding loan values.

As noted in our recent press releases, we are pursuing various strategic opportunities to strengthen our capital base and to enhance the performance of the bank. Again, thank you for your support of Allegiance Bank.

Sincerely,



Gregg J. Wagner  
President and CEO

***Allegiance Bank of North America***

Consolidated Financial Report

December 31, 2008



# *Allegiance Bank of North America*

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## **Table of Contents**

**December 31, 2008 and 2007**

	<u><b>Page</b></u>
<b>Independent Auditor's Report</b>	1
<b>Consolidated Financial Statements</b>	
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Stockholders' Equity	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	7





## Independent Auditor's Report

To the Board of Directors  
Allegiance Bank of North America  
Bala Cynwyd, Pennsylvania

We have audited the accompanying consolidated balance sheets of Allegiance Bank of North America and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Allegiance Bank of North America and its subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

*Beard Miller Company LLP*

Beard Miller Company LLP  
Allentown, Pennsylvania  
April 30, 2009

# Allegiance Bank of North America

## Consolidated Balance Sheets

December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
	(In Thousands, Except Share Data)	
<b>Assets</b>		
Cash and due from banks	\$ 838	\$ 664
Interest-bearing demand deposits	4,744	1,117
Federal funds sold	26	34
	<hr/>	<hr/>
Cash and Cash Equivalents	5,608	1,815
Interest bearing time deposits	50	475
Securities available for sale	21,038	21,911
Loans receivable, net of allowance for loan losses 2008 \$5,148; 2007 \$3,616	126,564	120,013
Bank premises and equipment, net	2,786	2,900
Restricted bank stock	1,753	1,273
Accrued interest receivable	791	866
Foreclosed assets	1,082	717
Other assets	615	669
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<b>Total Assets</b>	<b>\$160,287</b>	<b>\$150,639</b>
	<hr/> <hr/>	<hr/> <hr/>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Demand, non-interest bearing	\$ 8,055	\$ 7,831
Demand, interest bearing	38,905	30,338
Savings	997	1,559
Time, \$100,000 and over	39,029	31,241
Time, other	40,109	35,103
	<hr/>	<hr/>
Total Deposits	127,095	106,072
Short-term debt	4,142	10,556
Long-term debt	12,661	12,682
Accrued interest payable	77	162
Other liabilities	943	535
	<hr/>	<hr/>
<b>Total Liabilities</b>	<b>144,918</b>	<b>130,007</b>
	<hr/>	<hr/>
<b>Stockholders' Equity</b>		
Preferred stock, par value \$1.00 per share; authorized 2,000,000 shares; issued none	-	-
Common stock, par value \$1.00 per share; authorized 20,000,000 shares; issued and outstanding 4,798,062 shares	4,798	4,798
Surplus	19,911	19,800
Accumulated deficit	(9,431)	(4,057)
Accumulated other comprehensive income	91	91
	<hr/>	<hr/>
<b>Total Stockholders' Equity</b>	<b>15,369</b>	<b>20,632</b>
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<b>Total Liabilities and Stockholders' Equity</b>	<b>\$160,287</b>	<b>\$150,639</b>
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See notes to consolidated financial statements.

# *Allegiance Bank of North America*

## Consolidated Statements of Operations

Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
	(In Thousands, Except Per Share Amounts)		
<b>Interest Income</b>			
Loans receivable, including fees	\$ 9,033	\$10,004	\$ 9,228
Securities, taxable	1,458	1,149	743
Other	44	26	39
<b>Total Interest Income</b>	<b>10,535</b>	<b>11,179</b>	<b>10,010</b>
<b>Interest Expense</b>			
Deposits	4,006	4,178	3,272
Short-term debt	467	848	483
Long-term debt	544	114	39
<b>Total Interest Expense</b>	<b>5,017</b>	<b>5,140</b>	<b>3,794</b>
<b>Net Interest Income</b>	<b>5,518</b>	<b>6,039</b>	<b>6,216</b>
<b>Provision for Loan Losses</b>	<b>2,513</b>	<b>1,646</b>	<b>584</b>
<b>Net Interest Income after Provision for Loan Losses</b>	<b>3,005</b>	<b>4,393</b>	<b>5,632</b>
<b>Other Income</b>			
Customer service fees	101	90	73
Mortgage banking fees	19	107	111
Realized net gains on sales of securities	58	-	-
Loss on disposal of premises and equipment	(35)	-	-
Other	26	20	20
<b>Total Other Income</b>	<b>169</b>	<b>217</b>	<b>204</b>
<b>Other Expenses</b>			
Salaries and employee benefits	4,245	3,831	3,078
Occupancy	1,032	1,017	677
Equipment and data processing	588	618	536
Advertising, marketing and business development	376	254	318
Professional fees	784	430	382
Bank shares tax	184	143	102
Other	1,339	892	586
<b>Total Other Expenses</b>	<b>8,548</b>	<b>7,185</b>	<b>5,679</b>
<b>Net Income (Loss)</b>	<b>\$(5,374)</b>	<b>\$(2,575)</b>	<b>\$ 157</b>
<b>Earnings (Loss) Per Share</b>			
Basic	<b>\$(1.12)</b>	<b>\$(0.54)</b>	<b>\$0.03</b>
Diluted	<b>\$(1.12)</b>	<b>\$(0.54)</b>	<b>\$0.03</b>

*See notes to consolidated financial statements.*

# *Allegiance Bank of North America*

## Consolidated Statements of Stockholders' Equity Years Ended December 31, 2008, 2007 and 2006

	Common Stock	Surplus	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
	(Dollars In Thousands)				
<b>Balance - December 31, 2005</b>	\$4,781	\$19,595	\$(1,438)	\$(110)	\$22,828
Comprehensive income:					
Net income	-	-	157	-	157
Net change in unrealized gains (losses) on securities available for sale	-	-	-	35	35
<b>Total Comprehensive Income</b>					192
Exercise of 17,304 stock options	17	45	-	-	62
Compensation expense related to stock option grants	-	127	-	-	127
<b>Balance - December 31, 2006</b>	4,798	19,767	(1,281)	(75)	23,209
Comprehensive loss:					
Net loss	-	-	(2,575)	-	(2,575)
Net change in unrealized gains (losses) on securities available for sale	-	-	-	166	166
<b>Total Comprehensive Loss</b>					(2,409)
Subsidiary partnership, distributions to minority interest	-	-	(201)	-	(201)
Compensation expense related to stock option grants	-	33	-	-	33
<b>Balance - December 31, 2007</b>	4,798	19,800	(4,057)	91	20,632
Comprehensive loss:					
Net loss	-	-	(5,374)	-	(5,374)
Net change in unrealized gains (losses) on securities available for sale	-	-	-	-	-
<b>Total Comprehensive Loss</b>					(5,374)
Compensation expense related to stock option grants	-	111	-	-	111
<b>Balance - December 31, 2008</b>	<u>\$4,798</u>	<u>\$19,911</u>	<u>\$(9,431)</u>	<u>\$ 91</u>	<u>\$15,369</u>

*See notes to consolidated financial statements.*

# Allegiance Bank of North America

## Consolidated Statements of Cash Flows Years Ended December 31, 2008, 2007 and 2006

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(In Thousands)	
<b>Cash Flows from Operating Activities</b>			
Net income (loss)	\$(5,374)	\$ (2,575)	\$ 157
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Provision for loan losses	2,513	1,646	584
Provision for depreciation and amortization	530	541	392
Net (accretion) amortization of securities premiums (discounts)	28	69	(12)
Compensation expense for stock option grants	111	33	127
Net realized gains on sale of securities	(58)	-	-
Net realized gains on sale of foreclosed assets	(1)	-	-
Loss on disposal of premises and equipment	35	-	-
Deferred income taxes	-	137	(97)
(Increase) decrease in accrued interest receivable	75	(156)	(102)
(Increase) decrease in other assets	54	(343)	(123)
Increase (decrease) in accrued interest payable	(85)	57	13
Increase (decrease) in other liabilities	408	(376)	(94)
<b>Net Cash Provided by (Used in) Operating Activities</b>	<u>(1,764)</u>	<u>(967)</u>	<u>845</u>
<b>Cash Flows from Investing Activities</b>			
(Increase) decrease in interest bearing time deposits	425	(475)	-
Purchases of securities available for sale	(10,990)	(14,694)	(40,613)
Proceeds from maturities of and principal repayments on securities available for sale	7,920	20,288	33,559
Proceeds from sale of securities	3,973	-	-
Net increase in loans	(9,732)	(26,019)	(40)
Proceeds from sale of foreclosed assets	304	-	-
Purchases of bank premises and equipment	(451)	(494)	(2,119)
Net (increase) decrease in restricted bank stock	(480)	(507)	151
<b>Net Cash Used in Investing Activities</b>	<u>(9,031)</u>	<u>(21,901)</u>	<u>(9,062)</u>
<b>Cash Flows from Financing Activities</b>			
Net increase in deposits	21,023	9,247	13,180
Net increase (decrease) in short-term borrowings	(6,414)	2,006	(5,757)
Proceeds from long-term debt	-	12,000	-
Repayments of long-term debt	(21)	(19)	(18)
Proceeds from exercise of stock options	-	-	62
Subsidiary partnership, distributions to minority interest	-	(201)	-
<b>Net Cash Provided by Financing Activities</b>	<u>14,588</u>	<u>23,033</u>	<u>7,467</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>3,793</b>	<b>(165)</b>	<b>(750)</b>
<b>Cash and Cash Equivalents - Beginning</b>	<u>1,815</u>	<u>1,650</u>	<u>2,400</u>
<b>Cash and Cash Equivalents - Ending</b>	<u><u>\$ 5,608</u></u>	<u><u>\$ 1,815</u></u>	<u><u>\$ 1,650</u></u>

See notes to consolidated financial statements.

# ***Allegiance Bank of North America***

## **Consolidated Statements of Cash Flows** **Years Ended December 31, 2008, 2007 and 2006**

	<u>2008</u>	<u>2007</u> (In Thousands)	<u>2006</u>
<b>Supplementary Cash Flows Information</b>			
Interest paid	<u>\$5,102</u>	<u>\$5,083</u>	<u>\$ 3,781</u>
Income taxes paid	<u>\$ -</u>	<u>\$ 310</u>	<u>\$ 100</u>
<b>Supplementary Schedule on Noncash Investing and Financing Activities</b>			
Other real estate acquired in settlement of loans	<u>\$ 668</u>	<u>\$ 717</u>	<u>\$ -</u>

*See notes to consolidated financial statements.*

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies**

#### **Organization and Nature of Operations**

Allegiance Bank of North America (the Bank) was incorporated on December 24, 1998 under the laws of the Commonwealth of Pennsylvania and is a Pennsylvania state chartered bank. The Bank commenced operations on July 6, 1999 and is a full service bank providing personal and business lending and deposit services. As a state chartered, non-Federal Reserve member bank, the Bank is subject to regulation of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation. The area served by the Bank is southeastern Pennsylvania.

The consolidated financial statements include the accounts of Allegiance Bank of North America and its wholly-owned subsidiary, Allegiance Financial Services, Inc., and its 51% owned subsidiary, Paramount Mortgage and Capital, LLC (Paramount). Allegiance Financial Services, Inc. provides investment and insurance products and generates related fee income through a strategic alliance with the Walsh and Nicholson Financial Group. Paramount was formed on December 18, 2003 to broker and originate residential real estate loans and secured commercial loans. Residential mortgage loans originated by Paramount are generally funded by or sold to third parties to generate mortgage banking income. Secured commercial loans made primarily to small real estate investors and developers are held by Paramount and funded by loans to Paramount from the Bank. All intercompany transactions and balances have been eliminated in consolidation. On March 1, 2008, the Bank approved an action to close down Paramount due to a rise in delinquencies on their commercial loans. There is no minority interest recorded for Paramount due to accumulated losses of Paramount.

#### **Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses and the valuation of deferred tax assets.

#### **Significant Group Concentrations of Credit Risk**

Most of the Bank's activities are with customers located within southeastern Pennsylvania. Note 3 discusses the types of securities that the Bank invests in. Note 4 discusses the types of lending that the Bank engages in. The Bank does not have any significant loan concentrations to any one industry or customer. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.

#### **Presentation of Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and interest-bearing demand deposits. Generally, federal funds are purchased and sold for one day periods.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Securities**

Securities classified as available for sale are those securities that the Bank intends to hold for an indefinite period of time but not necessarily to maturity. Securities available for sale are carried at fair value. Any decision to sell a security classified as available for sale would be based on various factors, including significant movement in interest rates, changes in maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Unrealized gains and losses are reported as increases or decreases in other comprehensive income. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Declines in the fair value of available for sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

#### **Loans Receivable**

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Discounts and premiums on purchased loans are amortized to income using the interest method over the expected lives of the loans. Loan origination fees and loan origination costs are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Bank is generally amortizing these amounts over the contractual life of the loan.

The accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

#### **Allowance for Loan Losses**

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Allowance for Loan Losses (Continued)**

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and home equity loans for impairment disclosures, unless such loans are subject to a restructuring agreement.

#### **Foreclosed Assets**

Foreclosed assets are comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. A loan is classified as in-substance foreclosure when the Bank has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Foreclosed assets initially are recorded at fair value, net of estimated selling costs, at the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and changes in the valuation allowance are included in other expenses.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Restricted Investment in Bank Stock**

Restricted bank stock is primarily comprised of stock in the Federal Home Loan Bank of Pittsburgh (FHLB). Federal law requires a member institution of the FHLB to hold stock according to a predetermined formula. As of December 31, 2008 and 2007, the Bank had an investment of \$1,723,000 and \$1,243,000, respectively, related to the FHLB stock. Also included in restricted stock is Atlantic Central Bankers Bank stock in the amount of \$30,000. All restricted stock is carried at cost.

In December 2008, the FHLB notified member banks that it was suspending dividend payments and the repurchase of capital stock to preserve capital.

Management evaluates the restricted stock for impairment in accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB.

Management believes no impairment charge is necessary related to the FHLB restricted stock as of December 31, 2008.

#### **Transfers of Financial Assets**

Transfers of financial assets, including loan participation sales, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets as follows:

	<u>Years</u>
Leasehold improvements	5 - 10
Furniture, fixtures and equipment	5 - 10
Computer equipment and data processing software	3 - 5
Automobiles	3

#### **Advertising Costs**

The Bank follows the policy of charging the costs of advertising to expense as incurred.

#### **Income Taxes**

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carryforwards and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

#### **Off-Balance Sheet Financial Instruments**

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the balance sheet when they are funded.

#### **Share-Based Compensation**

The Bank currently has stock option plans in place for employees and directors of the Bank. The Bank accounts for stock options under the fair value recognition provisions of the Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*. Compensation expense is measured based on the grant date fair value of the stock option and is recognized over the service period, which is usually the vesting period. The Bank uses the Black-Scholes option pricing model to estimate the fair value of each option grant. Compensation expense related to stock options was \$111,000, \$33,000 and \$127,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

# *Allegiance Bank of North America*

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 1 - Summary of Significant Accounting Policies (Continued)

#### Earnings (Loss) per Common Share

Basic earnings (loss) per share represents income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income (loss) that would result from the assumed issuance. Potential common shares included in the computations relate solely to outstanding stock options and are determined using the treasury stock method.

The following table shows the amounts used in computing earnings (loss) per share for the years ended December 31, 2008, 2007 and 2006:

	Net Income (Loss)	Weighted Average Common Shares Outstanding	Earnings (Loss) Per Share
	(Dollars In Thousands, Except Per Share Amounts)		
<b>2008:</b>			
Basic	\$(5,374)	4,798,062	\$(1.12)
Dilutive effect of potential common stock, stock options	-	-	-
	<u>\$(5,374)</u>	<u>4,798,062</u>	<u>\$(1.12)</u>
Diluted			
	<u>\$(5,374)</u>	<u>4,798,062</u>	<u>\$(1.12)</u>
<b>2007:</b>			
Basic	\$(2,575)	4,798,062	\$(0.54)
Dilutive effect of potential common stock, stock options	-	-	-
	<u>\$(2,575)</u>	<u>4,798,062</u>	<u>\$(0.54)</u>
Diluted			
	<u>\$(2,575)</u>	<u>4,798,062</u>	<u>\$(0.54)</u>
<b>2006:</b>			
Basic	\$ 157	4,784,518	\$0.03
Dilutive effect of potential common stock, stock options	-	25,810	-
	<u>\$ 157</u>	<u>4,810,328</u>	<u>\$0.03</u>
Diluted			
	<u>\$ 157</u>	<u>4,810,328</u>	<u>\$0.03</u>

There was no dilutive effect of stock options for the years ended December 31, 2008 and 2007 due to the net loss incurred. Stock options for 242,442 shares of common stock were not considered in computing diluted earnings per share for 2006 because they were anti-dilutive.

# ***Allegiance Bank of North America***

## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Comprehensive Income**

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income (loss) for the years ended December 31 are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(In Thousands)	
Unrealized holding gains (losses) on securities available for sale	\$(58)	\$166	\$35
Less reclassification adjustment for gains included in net income	<u>58</u>	<u>-</u>	<u>-</u>
<b>Net Unrealized Gains (Losses)</b>	<u>\$ -</u>	<u>\$166</u>	<u>\$35</u>

#### **Segment Reporting**

The Bank acts as an independent community financial services provider, and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine networks, the Bank offers a full array of commercial and retail financial services, including taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services. Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, and consumer banking operations of the Bank. As such, discrete financial information is not available and segment reporting would not be meaningful. Paramount's operations are managed separately from the traditional banking and related financial services that the Bank offers. See Note 2 for segment reporting of Paramount.

#### **Reclassification**

Certain amounts in the 2007 and 2006 financial statements have been reclassified to conform with the 2008 presentation format. These reclassifications had no effect on net income.

# Allegiance Bank of North America

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 2 - Segment Reporting

Segment information for 2008, 2007 and 2006 is as follows:

	<b>Banking and Financial Services</b>	<b>Paramount</b>	<b>Total</b>
		(In Thousands)	
<b>Year ending December 31, 2008:</b>			
Net interest income from external sources	\$ 5,148	\$ 370	\$ 5,518
Loss before income taxes	(2,794)	(2,580)	(5,374)
Total assets	151,272	9,015	160,287
<b>Year ending December 31, 2007:</b>			
Net interest income from external sources	\$ 4,993	\$ 1,046	\$ 6,039
Loss before income taxes	(1,307)	(1,268)	(2,575)
Total assets	134,796	15,843	150,639
<b>Year ending December 31, 2006:</b>			
Net interest income from external sources	\$ 5,498	\$ 718	\$ 6,216
Income before income taxes	43	114	157
Total assets	119,352	10,949	130,301

### Note 3 - Securities Available for Sale

The amortized cost and approximate fair value of securities at December 31, 2008 and 2007 are summarized as follows:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
		(In Thousands)		
<b>December 31, 2008:</b>				
U.S. Government agencies	\$16,167	\$128	\$ -	\$16,295
Mortgage-backed securities	4,773	89	(126)	4,733
Mutual fund	10	-	-	10
	<u>\$20,950</u>	<u>\$217</u>	<u>\$(126)</u>	<u>\$21,038</u>
<b>December 31, 2007:</b>				
U.S. Government agencies	\$11,394	\$ 45	\$ -	\$11,439
Mortgage-backed securities	10,426	62	(16)	10,472
	<u>\$21,820</u>	<u>\$107</u>	<u>\$(16)</u>	<u>\$21,911</u>

# Allegiance Bank of North America

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 3 - Securities Available for Sale (Continued)

The amortized cost and fair value of securities as of December 31, 2008, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because the borrowers may have the right to prepay obligations with or without any penalties.

	<u>Amortized Cost</u>	<u>Fair Value</u>
	(In Thousands)	
Due in one year or less	\$ 1,000	\$ 1,014
Due after one year through five years	2,670	2,733
Due after five years through ten years	1,500	1,508
Due after 10 years	10,997	11,040
Mortgage-backed securities	4,773	4,733
Equity securities	10	10
	<u>\$20,950</u>	<u>\$21,038</u>

During the year ended December 31, 2008, gross gains of \$58,000 and gross losses of \$-0- were realized on sale of securities. There were no sales of securities during the years ended December 31, 2007 and 2006.

Securities with a carrying value of \$21,038,000 and \$11,439,000 at December 31, 2008 and 2007, respectively, were pledged to secure public deposits as required or permitted by law.

The following tables show the Bank's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2008 and 2007:

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
	(In Thousands)					

#### December 31, 2008

Mortgage-backed securities	<u>\$441</u>	<u>\$(17)</u>	<u>\$1,085</u>	<u>\$(109)</u>	<u>\$1,526</u>	<u>\$(126)</u>
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#### December 31, 2007

Mortgage-backed securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$1,561</u>	<u>\$(16)</u>	<u>\$ 1,561</u>	<u>\$(16)</u>
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In management's opinion, the unrealized losses primarily reflect changes in interest rates subsequent to the acquisition of specific securities. At December 31, 2008, the Bank had four securities in an unrealized loss position. The Bank has the intent and the ability to hold such securities until maturity or market price recovery. Management believes that the unrealized losses represent temporary impairment of the securities.

# *Allegiance Bank of North America*

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 4 - Loans Receivable and Allowance for Loan Losses

The composition of net loans receivable at December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Commercial real estate	\$ 79,188	\$ 71,996
Commercial construction	17,854	23,742
Commercial	7,998	11,276
Residential real estate	14,670	10,164
Home equity	11,317	6,814
Consumer	860	80
<b>Total Loans</b>	<b>131,887</b>	<b>124,072</b>
Unearned net loan origination fees	(175)	(443)
Allowance for loan losses	(5,148)	(3,616)
<b>Net Loans</b>	<b><u>\$126,564</u></b>	<b><u>\$120,013</u></b>

The changes in the allowance for loan losses for the years ended December 31, 2008, 2007, and 2006 are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(In Thousands)		
Balance, beginning	\$3,616	\$1,947	\$1,464
Provision for loan losses	2,513	1,646	584
Loans charged off	(1,199)	(53)	(104)
Recoveries	218	76	3
Balance, ending	<b><u>\$5,148</u></b>	<b><u>\$3,616</u></b>	<b><u>\$1,947</u></b>

The following is a summary of information pertaining to impaired and non-accrual loans at and for the years ended December 31:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Impaired loans without a valuation allowance	\$ 5,125	\$3,696
Impaired loans with a valuation allowance	8,249	4,664
<b>Total Impaired Loans</b>	<b><u>\$13,374</u></b>	<b><u>\$8,360</u></b>
Valuation allowance related to impaired loans	\$ 2,772	\$1,595
Total non-accrual loans	\$ 8,904	\$3,928
Total loans past due ninety days or more and still accruing	\$ -	\$ 952

# *Allegiance Bank of North America*

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 4 - Loans Receivable and Allowance for Loan Losses (Continued)

	Years Ended December 31,		
	2008	2007	2006
		(In Thousands)	
Average investment in impaired loans	\$8,491	\$4,952	\$1,154
Interest income recognized on impaired loans	-	166	33
Interest income recognized on a cash basis on impaired loans	-	166	33

### Note 5 - Bank Premises and Equipment

The components of bank premises and equipment at December 31, 2008 and 2007 are as follows:

	2008	2007
	(In Thousands)	
Leasehold improvements	\$2,955	\$2,682
Furniture, fixtures and equipment	943	959
Computer equipment and data processing software	1,210	1,013
Automobiles	22	84
	5,130	4,738
Accumulated depreciation	(2,344)	(1,838)
	<u>\$2,786</u>	<u>\$2,900</u>

Depreciation expense for the years ended December 31, 2008, 2007 and 2006 amounted to \$530,000, \$541,000 and \$392,000, respectively.

### Note 6 - Deposits

Included in time deposits at December 31, 2008 and 2007 are brokered deposits of \$17,969,000 and \$15,615,000, respectively.

At December 31, 2008, the scheduled maturities of time deposits are as follows (in thousands):

2009	\$41,620
2010	34,059
2011	1,644
2012	1,055
2013	760
	<u>\$79,138</u>

# ***Allegiance Bank of North America***

## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 7 - Borrowings**

The Bank has a line of credit commitment from the Federal Home Loan Bank (FHLB) for borrowings up to \$16,200,000 expiring January 24, 2012. Borrowings under this line of credit at December 31, 2008 and 2007 were \$4,142,000 and \$10,556,000 with interest at 0.64% and 3.84%, respectively.

The Bank also has a line of credit commitment with Atlantic Central Bankers Bank for unsecured borrowings up to \$1,000,000, which is renewable annually. Borrowings under this line of credit at December 31, 2008 and 2007 were \$-0-.

Long-term debt at December 31, 2008 and 2007 consisted of the following notes with the FHLB:

<u>Maturity Date</u>	<u>Initial Conversion Date</u>	<u>Interest Rate</u>	<u>2008</u>	<u>2007</u>
			(In Thousands)	
May 2027	N/A	5.45%	\$ 661	\$ 682
November 2010	N/A	4.09%	3,000	3,000
November 2011	N/A	4.33%	3,000	3,000
November 2012	November 2009	3.68%	6,000	6,000
			<u>\$12,661</u>	<u>\$12,682</u>

The convertible note contains a conversion option which allows the FHLB at quarterly intervals commencing after the initial conversion date to convert the fixed convertible advance into replacement funding for the same or lesser principal amount based on any advance offered by the FHLB at their current market rates. The Bank has the option to repay this advance, if converted, without penalty.

Expected maturities of long-term debt in years subsequent to December 31, 2008 are as follows (in thousands):

2009	\$ 21
2010	3,023
2011	3,024
2012	6,025
2013	27
Thereafter	541
	<u>\$12,661</u>

Advances from the FHLB are secured by certain qualifying assets of the Bank. The Bank has a maximum borrowing capacity with the FHLB of approximately \$41,000,000 at December 31, 2008, of which \$16,803,000 was outstanding.

# ***Allegiance Bank of North America***

## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 8 - Lease Commitments and Total Rental Expense**

The Bank leases the premises for its main banking office under a seven-year operating lease agreement expiring July 2010. The Bank has the option to extend the lease agreement for one additional five year period. The Bank may be required to pay additional rent for its portion of certain increases in operating costs over the base year costs, as determined by the landlord.

The Bank also leases the premises for a branch that opened in 2005 under a ten-year operating lease agreement expiring October 2014. The Bank has the option to extend this lease agreement for two additional five-year periods.

The Bank also leases the premises for three new branches that opened in 2006. The first lease is under a five-year operating lease agreement expiring August 2010. The Bank has the option to extend this lease agreement for three additional five-year periods. The second lease is under a ten-year operating lease agreement expiring November 2015. The Bank has the option to extend this lease agreement for three additional five-year periods. The third lease is under a ten-year operating lease agreement expiring November 2015. The Bank has an option to extend this lease agreement for three additional five-year periods.

The Bank is responsible for paying all real estate taxes and utilities pertaining to these premises.

Future minimum lease payments by year are as follows (in thousands):

2009	\$ 455
2010	377
2011	268
2012	268
2013	268
Thereafter	<u>551</u>
	<u><u>\$2,187</u></u>

Total rent expense was \$550,000, \$578,000 and \$413,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

### **Note 9 - Employment Agreement**

The Bank had an employment agreement with its chief executive officer which includes minimum annual salary commitments and change of control provisions. The Bank terminated that agreement in 2008 and paid the former chief executive officer severance which was recorded in compensation expense in 2008 in accordance with the employment agreement.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 10 - Employee Benefit Plan**

The Bank has a 401(k) profit sharing plan for its employees. Employees may contribute an elective deferral percentage of their salary to the Plan each year, subject to limitations which are set by law. The Bank provides a matching contribution equal to 50% of the amount the employee elects to defer limited to 6% of each employee's annual compensation. The Bank may also make discretionary contributions. The employer contribution charged to expense for the years ended December 31, 2008, 2007 and 2006 was \$50,000, \$58,000 and \$43,000, respectively.

### **Note 11 - Stock Option Plans**

The Bank has a 2000 Stock Option Plan to provide for the granting of stock options to employees, outside directors, certain consultants and organizers of the Bank. Under the Plan, the Board may grant "incentive stock options" and "non-qualified stock options," provided that only employees of the Bank will be eligible to receive incentive stock options. A total of 293,760 shares of common stock have been reserved for issuance under the Plan.

On May 21, 2003, the Bank adopted the 2003 Stock Option Plan to provide for the granting of stock options to employees and outside directors of the Bank. Under the plan, the Board may grant "incentive stock options" and "non-qualified stock options," provided that only employees of the Bank will be eligible to receive incentive stock options. A total of 120,000 shares have been reserved for issuance under the Plan, including 84,000 shares specifically reserved for grants to employees.

In September 2005, the Board of Directors approved the 2005 Stock Option Plan to provide for the granting of stock options to employees and outside directors of the Bank. Under the Plan, the Board may grant "incentive stock options" and "non-qualified stock options," provided that only employees of the Bank will be eligible to receive incentive stock options. A total of 700,000 shares less options outstanding from time to time under the Bank's 2000 Stock Option Plan and 2003 Stock Option Plan and shares issued upon exercise of options granted under the 2000 Stock Option Plan and 2003 Stock Option Plan have been reserved for the issuance under the Plan. The 2005 Stock Option Plan was approved by the shareholders in May 2006. As of December 31, 2008, there were 106,268 options available for grant under this Plan.

The option price of options granted under the Plans cannot be less than the fair market value of the common stock at the date of grant. The vesting of employee stock options under the Plans is at the discretion of the committee awarding the options.

# Allegiance Bank of North America

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 11 - Stock Option Plans (Continued)

The following summarizes changes in stock options outstanding for the years ended December 31, 2008, 2007 and 2006:

	<u>Number of Shares</u>	<u>Weighted Average Price</u>	<u>Weighted Average Remaining Life</u>	<u>Aggregate Intrinsic Value</u>
Outstanding, December 31, 2005	332,765	\$5.14		
Granted	109,100	5.50		
Exercised	(17,304)	3.55		
Forfeited	(36,102)	4.83		
Outstanding, December 31, 2006	388,459	5.34		
Granted	17,500	5.07		
Forfeited	(34,012)	3.84		
Outstanding, December 31, 2007	371,947	5.39		
Granted	<b>209,525</b>	<b>2.14</b>		
Forfeited	<b>(8,500)</b>	<b>3.94</b>		
Outstanding, December 31, 2008	<u><b>572,972</b></u>	<u><b>\$4.22</b></u>	<u><b>5.78</b></u>	<u><b>\$ -</b></u>
Exercisable, December 31, 2008	<u><b>537,473</b></u>	<u><b>\$4.28</b></u>	<u><b>5.58</b></u>	<u><b>\$ -</b></u>
Exercisable, December 31, 2007	<u>338,680</u>	<u>\$5.38</u>		

The total intrinsic value or fair market price over the exercise price of stock options exercised was \$30,292 during the year ended December 31, 2006.

The Bank used the Black-Scholes option pricing model to estimate the fair value of stock option awards. The following assumptions were used to estimate the fair values of options granted for the years ended December 31, 2008, 2007 and 2006:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Weighted average risk-free interest rate	<b>2.40 %</b>	4.68 %	4.80 %
Expected dividend yield	- %	- %	- %
Weighted average volatility factor of the expected market price of the Bank's common stock	<b>24.01 %</b>	11.84 %	10.30 %
Weighted average expected life of the options	<b>5.0 years</b>	6.5 years	5.4 years
Weighted average fair value of options granted	<b>\$0.54</b>	\$1.43	\$1.35

# *Allegiance Bank of North America*

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 11- Stock Option Plans (Continued)

Total share-based compensation cost for the years ended December 31, 2008, 2007 and 2006 was \$111,000, \$33,000 and \$127,000, respectively, related to the above stock option plans. There were no tax benefits recognized related to share-based compensation.

As of December 31, 2008, there was \$13,000 of unrecognized compensation cost related to nonvested stock options at December 31, 2008. That cost is expected to be recognized over a weighted average period of 1.5 years.

### Note 12 - Federal Income Taxes

The components of income tax expense for the years ended December 31, 2008, 2007, and 2006 are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(In Thousands)	
Current	\$ -	\$(137)	\$234
Deferred	-	137	(97)
Benefit from the utilization of net operating loss carryforwards	-	-	(137)
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The components of the net deferred tax asset at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
		(In Thousands)
Deferred tax assets:		
Allowance for loan losses	\$ 1,750	\$1,229
Net operating loss carryforwards	985	411
Bank premises and equipment	44	107
Non-qualified stock option	70	38
Other	97	162
<b>Total Deferred Tax Assets</b>	<b>2,946</b>	1,947
Valuation allowance	<u>(2,872)</u>	<u>(1,836)</u>
<b>Total Deferred Tax Assets, Net of Valuation Allowance</b>	<b>74</b>	111
Deferred tax liabilities, cash basis conversion	<u>(74)</u>	<u>(111)</u>
<b>Net Deferred Tax Asset</b>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 12 - Federal Income Taxes (Continued)**

Effective January 1, 2007, the Bank adopted the provisions of Financial Accounting Standards (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. The Interpretation provides clarification on accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the Bank's evaluation of the implementation of FIN 48, no significant income tax uncertainties were identified. Therefore, the Bank recognized no adjustment for unrecognized income tax benefits for the year ended December 31, 2008. Our policy is to recognize interest and penalties on unrecognized tax benefits in income taxes expense in the Consolidated Statements of Operations. The amount of interest and penalties for the years ended December 31, 2008 and 2007 were immaterial. The tax years subject to examination by the taxing authorities are the years ended December 31, 2007, 2006, 2005 and 2004.

### **Note 13 - Transactions with Executive Officers, Directors and Principal Stockholders**

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. At December 31, 2008 and 2007 these persons were indebted to the Bank for loans totaling \$471,000 and \$420,000, respectively. During the year ended December 31, 2008, \$79,000 of new loans were made and repayments totaled \$28,000. Deposits of related parties totaled \$877,000 and \$737,000 at December 31, 2008 and 2007, respectively.

### **Note 14 - Financial Instruments with Off-Balance Sheet Risk**

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

# ***Allegiance Bank of North America***

## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 14 - Financial Instruments with Off-Balance Sheet Risk (Continued)**

A summary of the Bank's financial instrument commitments at December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Commitments to grant loans	\$ 265	\$ 929
Unfunded commitments under lines of credit	18,058	21,856
Outstanding letters of credit	622	942

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

Outstanding letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds through liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The amount of the liability as of December 31, 2008 and 2007 for guarantees under standby letters of credit is not material.

### **Note 15 - Regulatory Matters**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2008 and 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

# Allegiance Bank of North America

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 15 - Regulatory Matters (Continued)

The Bank's actual capital amounts and ratios at December 31, 2008 and 2007 are presented below:

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of December 31, 2008:</b>						
Total capital (to risk-weighted assets)	\$16,799	14.23 %	\$29,447	≥8.0 %	\$211,809	≥10.0 %
Tier 1 capital (to risk-weighted assets)	15,278	12.94	≥4,724	≥4.0	≥ 7,085	≥ 6.0
Tier 1 capital (to average assets)	15,278	9.51	≥6,429	≥4.0	≥ 8,036	≥ 5.0
<b>As of December 31, 2007:</b>						
Total capital (to risk-weighted assets)	\$21,973	19.60 %	\$28,968	≥8.0 %	\$211,210	≥10.0 %
Tier 1 capital (to risk-weighted assets)	20,541	18.32	≥4,484	≥4.0	≥6,726	≥ 6.0
Tier 1 capital (to average assets)	20,541	13.86	≥5,928	≥4.0	≥7,411	≥ 5.0

The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations. The Pennsylvania Banking Code provides that cash dividends may be declared and paid only out of accumulated net earnings.

### Note 16 - Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Bank's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Bank could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year-ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year-end.

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. The Bank adopted SFAS 157 effective for its fiscal year beginning January 1, 2008.

In December 2007, the FASB issued FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157* ("FSP 157-2"). FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As such, the Bank only partially adopted the provisions of SFAS 157, and will begin to account and report for non-financial assets and liabilities in 2009. In October 2008, the FASB issued FASB Staff Position 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active* ("FSP 157-3"), to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP 157-3 is effective immediately and applies to the Bank's December 31, 2008 consolidated financial statements. The adoption of SFAS 157 and FSP 157-3 had no impact on the amounts reported in the financial statements.

# Allegiance Bank of North America

## Notes to Consolidated Financial Statements

December 31, 2008

### Note 16 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

The primary effect of SFAS 157 on the Bank was to expand the required disclosures pertaining to the methods used to determine fair values.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 are as follows:

*Level 1:* Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

*Level 2:* Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

*Level 3:* Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2008 are as follows:

Description	December 31, 2008	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(In Thousands)				
Securities available for sale	\$21,038	\$ -	\$21,038	\$ -

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2008 are as follows:

Description	December 31, 2008	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(In Thousands)				
Impaired loans	\$ 5,477	\$ -	\$ -	\$5,477

As discussed above, the Bank has delayed its disclosure requirements of non-financial assets and liabilities. Certain real estate owned are carried at fair value at the balance sheet date for which the Bank has not yet adopted the provisions of SFAS 157.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 16 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)**

The following information should not be interpreted as an estimate of the fair value of the entire Bank since a fair value calculation is only provided for a limited portion of the Bank's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Bank's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Bank's financial instruments at December 31, 2008 and 2007:

#### **Cash and Cash Equivalents (Carried at Cost)**

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

#### **Interest Bearing Time Deposits (Carried at Cost)**

Fair values for fixed-rate time certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits. The Bank generally purchases amounts below the insured limit, limiting the amount of credit risk on these time deposits.

#### **Securities**

The fair value of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) are used to support fair values of certain Level 3 investments, if applicable.

#### **Loans Receivable (Carried at Cost)**

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

# ***Allegiance Bank of North America***

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## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 16 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)**

#### **Impaired Loans (Generally Carried at Fair Value)**

Impaired loans are those that are accounted for under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* ("SFAS 114"), in which the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of loan balances of \$8,249,000, net of a valuation allowance of \$2,772,000. Additional provisions for loan losses of \$2,158,000 were recorded during the period.

#### **Restricted Investment in Bank Stock (Carried at Cost)**

The carrying amount of restricted investment in bank stock approximates fair value, and considers the limited marketability of such securities.

#### **Accrued Interest Receivable and Payable (Carried at Cost)**

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

#### **Deposit Liabilities (Carried at Cost)**

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

#### **Short-Term Debt (Carried at Cost)**

The carrying amount of short-term borrowings approximates their fair values.

#### **Long-Term Debt (Carried at Cost)**

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

# ***Allegiance Bank of North America***

## **Notes to Consolidated Financial Statements**

**December 31, 2008**

### **Note 16 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)**

#### **Off-Balance Sheet Financial Instruments (Disclosed at Cost)**

Fair values for the Bank's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Bank's financial instruments at December 31, 2008 and 2007 were as follows:

	<b>2008</b>		<b>2007</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
	<b>(In Thousands)</b>			
Financial assets:				
Cash and cash equivalents	\$ 5,608	\$ 5,608	\$ 1,815	\$ 1,815
Interest-bearing time deposits	50	50	475	475
Securities available for sale	21,038	21,038	21,911	21,911
Loans receivable, net	126,564	128,046	120,013	119,717
Restricted bank stock	1,753	1,753	1,273	1,273
Accrued interest receivable	791	791	866	866
Financial liabilities:				
Deposits	127,095	128,241	106,072	106,290
Short-term debt	4,142	4,142	10,556	10,556
Long-term debt	12,661	13,371	12,682	12,650
Accrued interest payable	77	77	162	162
Off-balance sheet financial instruments:				
Commitments to extend credit	-	-	-	-
Outstanding letters of credit	-	-	-	-

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## **BOARD OF DIRECTORS**

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**Chairman of the Board**  
Retired, EVP/CFO of CDI Corporation

**Robert S. Kramer**  
**Vice Chairman of the Board**  
President of Microcision, LLC

**Lynne C. Davis**  
CEO of The Davis Group

**Stanley H. Engle**  
Retired, President of Penn Distributors

**Amos B. Smith, III**  
Rhodes-Thompson Professor of Chemistry  
at the University of Pennsylvania

**Gregg J. Wagner**  
President and CEO of Allegiance Bank

## **SENIOR STAFF**

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Chief Executive Officer

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Executive Vice President  
Chief Lending Officer

**Diane R. Brown**  
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