

## Section 1: 10-Q (10-Q)

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

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**FORM 10-Q**

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**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2018

Commission file number 0-7674

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**FIRST FINANCIAL BANKSHARES, INC.**

(Exact name of registrant as specified in its charter)

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Texas  
(State or other jurisdiction of  
incorporation or organization)

400 Pine Street, Abilene, Texas  
(Address of principal executive offices)

75-0944023  
(I.R.S. Employer  
Identification No.)

79601  
(Zip Code)

(325) 627-7155  
(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Non-accelerated filer

Accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Class

Outstanding at October 30, 2018

Common Stock, \$0.01 par value per share

67,721,632

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**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The consolidated balance sheets of First Financial Bankshares, Inc. (the “Company” or “we”) at September 30, 2018 and 2017 and December 31, 2017, and the consolidated statements of earnings and comprehensive earnings for the three and nine months ended September 30, 2018 and 2017, and the consolidated statements of shareholders’ equity and cash flows for the nine months ended September 30, 2018 and 2017, follow on pages 4 through 8.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**(Dollars in thousands, except per share amounts)**

	<u>September 30,</u>		<u>December 31,</u>
	<u>2018</u>	<u>2017</u>	<u>2017</u>
	(Unaudited)		
<b>ASSETS</b>			
CASH AND DUE FROM BANKS	\$ 164,998	\$ 177,615	\$ 209,583
INTEREST-BEARING DEPOSITS IN BANKS	34,511	166,820	162,764
Total cash and cash equivalents	199,509	344,435	372,347
INTEREST-BEARING TIME DEPOSITS IN BANKS	1,458	1,458	1,458
SECURITIES AVAILABLE-FOR-SALE, at fair value	3,144,367	2,885,483	3,087,473
LOANS:			
Held for investment	3,867,040	3,472,227	3,485,569
Less-allowance for loan losses	(50,871)	(47,922)	(48,156)
Net loans held for investment	3,816,169	3,424,305	3,437,413
Held for sale	18,496	19,119	15,130
Net loans	3,834,665	3,443,424	3,452,543
BANK PREMISES AND EQUIPMENT, net	130,815	125,668	124,026
INTANGIBLE ASSETS	174,907	141,355	141,143
OTHER ASSETS	85,510	67,341	75,725
Total assets	<u>\$7,571,231</u>	<u>\$7,009,164</u>	<u>\$ 7,254,715</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
NONINTEREST-BEARING DEPOSITS	\$2,146,984	\$1,949,174	\$ 2,041,650
INTEREST-BEARING DEPOSITS	3,998,298	3,748,286	3,921,311
Total deposits	6,145,282	5,697,460	5,962,961
DIVIDENDS PAYABLE	14,216	12,580	12,589
BORROWINGS	380,760	351,435	331,000
OTHER LIABILITIES	35,234	41,133	25,397
Total liabilities	<u>6,575,492</u>	<u>6,102,608</u>	<u>6,331,947</u>
<b>COMMITMENTS AND CONTINGENCIES</b>			
<b>SHAREHOLDERS' EQUITY:</b>			
Common stock 0.01 par value, authorized 120,000,000 shares; 67,693,586, 66,223,957 and 66,260,444 shares issued at September 30, 2018 and 2017 and December 31, 2017, respectively)	677	662	663
Capital surplus	440,589	376,286	378,062
Retained earnings	582,449	493,706	517,257
Treasury stock (shares at cost: 471,070, 498,459, and 495,964 at September 30, 2018 and 2017 and December 31, 2017, respectively)	(7,512)	(7,028)	(7,148)
Deferred compensation	7,512	7,028	7,148
Accumulated other comprehensive earnings (loss)	(27,976)	35,902	26,786
Total shareholders' equity	<u>995,739</u>	<u>906,556</u>	<u>922,768</u>
Total liabilities and shareholders' equity	<u>\$7,571,231</u>	<u>\$7,009,164</u>	<u>\$ 7,254,715</u>

See notes to consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS - (UNAUDITED)**  
(Dollars in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 51,428	\$ 42,749	\$ 147,279	\$ 123,643
Interest on investment securities:				
Taxable	12,593	8,074	36,666	23,848
Exempt from federal income tax	9,558	11,091	29,882	33,991
Interest on federal funds sold and interest-bearing deposits in banks	470	640	1,382	1,037
Total interest income	74,049	62,554	215,209	182,519
<b>INTEREST EXPENSE:</b>				
Interest on deposits	4,330	2,228	11,854	5,748
Other	293	638	869	978
Total interest expense	4,623	2,866	12,723	6,726
Net interest income	69,426	59,688	202,486	175,793
<b>PROVISION FOR LOAN LOSSES</b>	1,450	1,415	3,865	5,090
Net interest income after provision for loan losses	67,976	58,273	198,621	170,703
<b>NONINTEREST INCOME:</b>				
Trust fees	7,291	6,040	21,265	17,804
Service charges on deposit accounts	5,690	5,083	15,950	14,517
ATM, interchange and credit card fees	7,533	6,340	21,570	19,102
Real estate mortgage operations	4,834	3,891	11,718	11,496
Net gain on sale of available-for-sale securities (includes \$58 and \$1,075 for the three months ended September 30, 2018 and 2017, respectively, and \$1,346 and \$1,825 for the nine months ended September 30, 2018 and 2017, respectively, related to accumulated other comprehensive earnings reclassifications)	58	1,075	1,346	1,825
Net gain (loss) on sale of foreclosed assets	84	(11)	201	(42)
Net gain (loss) on sale of assets	(61)	(15)	(152)	(211)
Interest on loan recoveries	199	405	607	896
Other	1,427	1,452	4,461	3,328
Total noninterest income	27,055	24,260	76,966	68,715
<b>NONINTEREST EXPENSE:</b>				
Salaries and employee benefits	26,377	24,143	79,442	70,867
Net occupancy expense	2,900	2,711	8,589	8,081
Equipment expense	3,482	3,294	10,438	10,397
FDIC insurance premiums	570	561	1,768	1,657
ATM, interchange and credit card expenses	2,344	2,001	6,692	5,517
Professional and service fees	2,174	2,036	6,613	5,878
Printing, stationery and supplies	387	449	1,485	1,423
Operational and other losses	981	1,081	1,852	2,639
Software amortization and expense	540	742	1,542	2,237
Amortization of intangible assets	279	143	1,049	477
Other	7,472	6,803	22,978	20,718
Total noninterest expense	47,506	43,964	142,448	129,891
<b>EARNINGS BEFORE INCOME TAXES</b>	47,525	38,569	133,139	109,527
<b>INCOME TAX EXPENSE</b> (includes \$12 and \$376 for the three months ended September 30, 2018 and 2017, respectively, and \$283 and \$639 for the nine months ended September 30, 2018 and 2017, respectively, related to income tax expense from reclassification items)	7,475	9,195	20,937	25,300
<b>NET EARNINGS</b>	\$ 40,050	\$ 29,374	\$ 112,202	\$ 84,227
<b>EARNINGS PER SHARE, BASIC</b>	\$ 0.59	\$ 0.44	\$ 1.66	\$ 1.27
<b>EARNINGS PER SHARE, ASSUMING DILUTION</b>	\$ 0.59	\$ 0.44	\$ 1.65	\$ 1.27
<b>DIVIDENDS PER SHARE</b>	\$ 0.21	\$ 0.19	\$ 0.61	\$ 0.56

See notes to consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS (LOSS) - (UNAUDITED)**  
**(Dollars in thousands)**

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>
<b>NET EARNINGS</b>	\$ 40,050	\$ 29,374	\$ 112,202	\$ 84,227
<b>OTHER ITEMS OF COMPREHENSIVE EARNINGS (LOSS):</b>				
Change in unrealized gain (loss) on investment securities available-for-sale, before income taxes	(20,930)	1,729	(75,236)	28,682
Reclassification adjustment for realized gains on investment securities included in net earnings, before income tax	(58)	(1,075)	(1,346)	(1,825)
Total other items of comprehensive earnings (loss)	(20,988)	654	(76,582)	26,857
Income tax benefit (expense) related to other items of comprehensive earnings	4,407	(229)	16,082	(9,400)
Reclassification of certain income tax effects related to the change in the U.S. statutory federal income tax rate under the Tax Cuts and Jobs Act to retained earnings	—	—	5,759	—
<b>COMPREHENSIVE EARNINGS</b>	<u>\$ 23,469</u>	<u>\$ 29,799</u>	<u>\$ 57,461</u>	<u>\$ 101,684</u>

See notes to consolidated financial statements.



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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
(Dollars in thousands, except per share amounts)

	Common Stock		Capital Surplus	Retained Earnings	Treasury Stock		Deferred Compensation	Accumulated Other Comprehensive Earnings	Total Shareholders' Equity
	Shares	Amount			Shares	Amounts			
Balances at December 31, 2016	66,094,695	\$ 661	\$372,245	\$446,534	(507,409)	\$ (6,671)	\$ 6,671	\$ 18,445	\$ 837,885
Net earnings (unaudited)	—	—	—	84,227	—	—	—	—	84,227
Stock option exercises (unaudited)	114,612	1	2,259	—	—	—	—	—	2,260
Restricted stock grant (unaudited)	14,650	—	600	—	—	—	—	—	600
Cash dividends declared, \$0.56 per share (unaudited)	—	—	—	(37,055)	—	—	—	—	(37,055)
Change in unrealized gain in investment securities available-for-sale, net of related income taxes (unaudited)	—	—	—	—	—	—	—	17,457	17,457
Shares purchased (redeemed) in connection with directors' deferred compensation plan, net (unaudited)	—	—	—	—	8,950	(357)	357	—	—
Stock option expense (unaudited)	—	—	1,182	—	—	—	—	—	1,182
Balances at September 30, 2017 (unaudited)	<u>66,223,957</u>	<u>\$ 662</u>	<u>\$376,286</u>	<u>\$493,706</u>	<u>(498,459)</u>	<u>\$ (7,028)</u>	<u>\$ 7,028</u>	<u>\$ 35,902</u>	<u>\$ 906,556</u>
Balances at December 31, 2017	66,260,444	\$ 663	\$378,062	\$517,257	(495,964)	\$ (7,148)	\$ 7,148	\$ 26,786	\$ 922,768
Net earnings (unaudited)	—	—	—	112,202	—	—	—	—	112,202
Stock option exercises (unaudited)	133,061	1	2,799	—	—	—	—	—	2,800
Restricted stock grant (unaudited)	10,710	—	523	—	—	—	—	—	523
Cash dividends declared, \$0.61 per share (unaudited)	—	—	—	(41,272)	—	—	—	—	(41,272)
Stock issued in acquisition of Commercial Bancshares, Inc.	1,289,371	13	58,074	—	—	—	—	—	58,087
Change in unrealized gain (loss) in investment securities available-for-sale, net of related income taxes (unaudited)	—	—	—	—	—	—	—	(60,500)	(60,500)
Shares purchased (redeemed) in connection with directors' deferred compensation plan, net (unaudited)	—	—	—	—	24,894	(364)	364	—	—
Stock option expense (unaudited)	—	—	1,131	—	—	—	—	—	1,131
Reclassification of certain income tax effects related to the change in the U.S. statutory federal income tax rate under the Tax Cuts and Jobs Act to retained earnings (unaudited)	—	—	—	(5,759)	—	—	—	5,759	—
Reclassification of unrealized gain in equity securities at December 31, 2017 from accumulated other comprehensive earnings to retained earnings (unaudited)	—	—	—	21	—	—	—	(21)	—
Balances at September 30, 2018 (unaudited)	<u>67,693,586</u>	<u>\$ 677</u>	<u>\$440,589</u>	<u>\$582,449</u>	<u>(471,070)</u>	<u>\$ (7,512)</u>	<u>\$ 7,512</u>	<u>\$ (27,976)</u>	<u>\$ 995,739</u>

See notes to consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS - (UNAUDITED)**  
(Dollars in thousands)

	Nine Months Ended September 30,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings	\$ 112,202	\$ 84,227
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	9,554	9,447
Provision for loan losses	3,865	5,090
Securities premium amortization (discount accretion), net	21,005	23,009
Gain on sale of assets, net	(1,254)	(1,572)
Deferred federal income tax benefit	8,107	1,290
Change in loans held-for-sale	(2,928)	7,779
Change in other assets	2,699	18,703
Change in other liabilities	5,653	7,172
Total adjustments	46,701	70,918
Net cash provided by operating activities	158,903	155,145
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Cash received in acquisition of Commercial Bancshares, Inc.	18,653	—
Net decrease in interest-bearing time deposits in banks	—	249
Activity in available-for-sale securities:		
Sales	220,259	120,576
Maturities	3,354,571	4,299,781
Purchases	(3,650,127)	(4,450,719)
Activity in held-to-maturity securities—maturities	—	124
Net increase in loans	(116,860)	(119,911)
Purchases of bank premises and equipment and other assets	(12,381)	(12,626)
Proceeds from sale of bank premises and equipment and other assets	810	4,857
Net cash used in investing activities	(185,075)	(157,669)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase (decrease) in noninterest-bearing deposits	(56,706)	231,452
Net increase in interest-bearing deposits	(102,875)	(12,531)
Net increase (decrease) in borrowings	49,760	(94,335)
Common stock transactions:		
Proceeds from stock issuances	2,800	2,260
Dividends paid	(39,645)	(36,373)
Net cash provided by (used in) financing activities	(146,666)	90,473
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	(172,838)	87,949
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	372,347	256,486
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<u>\$ 199,509</u>	<u>\$ 344,435</u>
<b>SUPPLEMENTAL INFORMATION AND NONCASH TRANSACTIONS:</b>		
Interest paid	\$ 12,617	\$ 6,772
Federal income taxes paid	20,351	21,896
Transfer of loans and bank premises to other real estate	126	2,044
Investment securities purchased but not settled	13,453	993
Restricted stocks grant to directors and officers	523	600
Stock issued in acquisition of Commercial Bancshares, Inc.	58,087	—

See notes to consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Note 1 - Basis of Presentation**

The unaudited interim consolidated financial statements include the accounts of the Company, a Texas corporation and a financial holding company registered under the Bank Holding Company Act of 1956, as amended, or BHCA, and its wholly-owned subsidiaries: First Financial Bank, National Association, Abilene, Texas; First Technology Services, Inc.; First Financial Trust & Asset Management Company, National Association; First Financial Investments, Inc.; and First Financial Insurance Agency, Inc.

Through our subsidiary bank, we conduct a full-service commercial banking business. Our banking centers are located primarily in Central, North Central, Southeast and West Texas. As of September 30, 2018, we had 72 financial centers across Texas, with eleven locations in Abilene, three locations in Weatherford, two locations in Cleburne, Conroe, San Angelo, Stephenville and Granbury, and one location each in Acton, Albany, Aledo, Alvarado, Beaumont, Boyd, Bridgeport, Brock, Burseson, Cisco, Clyde, Cut and Shoot, Decatur, Eastland, El Campo, Fort Worth, Fulshear, Glen Rose, Grapevine, Hereford, Huntsville, Keller, Kingwood, Magnolia, Mauriceville, Merkel, Midlothian, Mineral Wells, Montgomery, Moran, New Waverly, Newton, Odessa, Orange, Palacios, Port Arthur, Ranger, Rising Star, Roby, Southlake, Sweetwater, Tomball, Trent, Trophy Club, Vidor, Waxahachie, Willis and Willow Park, all in Texas. Our trust subsidiary has seven locations which are located in Abilene, Fort Worth, Odessa, Beaumont, San Angelo, Stephenville and Sweetwater.

In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments necessary for a fair presentation of the Company's financial position and unaudited results of operations and should be read in conjunction with the Company's audited consolidated financial statements, and notes thereto in the Company's Annual Report on Form 10-K, for the year ended December 31, 2017. All adjustments were of a normal recurring nature. However, the results of operations for the three and nine months ended September 30, 2018, are not necessarily indicative of the results to be expected for the year ending December 31, 2018, due to seasonality, changes in economic conditions and loan credit quality, interest rate fluctuations, regulatory and legislative changes and other factors. The preparation of financial statements in conformity with United States generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the financial statement date. Actual results could vary. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted under U.S. Securities and Exchange Commission ("SEC") rules and regulations. The Company evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements were issued.

Goodwill and other intangible assets are evaluated annually for impairment as of the end of the second quarter. No such impairment has been noted in connection with the current or any prior evaluations.

**New Revenue Recognition Standard**

ASC 606, "Revenue from Contracts with Customers" established principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of the Company's revenue is derived from loan and investment income which are specifically excluded from the scope of this standard. Of the Company's remaining sources of income, substantially all sources of revenue are recognized either by transaction (ATM, interchange, wire transfer,

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etc.) or when the Company charges a customer for a service that has already been rendered (monthly service charges, account fees, monthly trust management fees, etc.). Payment for such performance obligations are generally received at the time the performance obligations are satisfied. Other non-interest income primarily includes items such as letter of credit fees, gains on the sale of loans held for sale and servicing fees, none of which are subject to the requirements of ASC 606. See note 13 for additional discussion related to the Company's adoption of ASC 606.

### **Note 2 – Stock Repurchase**

On July 25, 2017, the Company's Board of Directors authorized the repurchase of up to 2,000,000 common shares through September 30, 2020. The shares buyback plan authorizes management to repurchase the shares at such time as repurchases are considered beneficial to shareholders. Any repurchase of shares will be made through the open market, block trades or in privately negotiated transactions in accordance with applicable laws and regulations. Under the repurchase plan, there is no minimum number of shares that the Company is required to repurchase. Through September 30, 2018, no shares were repurchased under this authorization.

### **Note 3 - Earnings Per Share**

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding during the periods presented. In computing diluted earnings per common share for the three months and nine months ended September 30, 2018, and 2017, the Company assumes that all dilutive outstanding options to purchase common shares have been exercised at the beginning of the period (or the time of issuance, if later). The dilutive effect of these outstanding options and the restricted shares is reflected by application of the treasury stock method, whereby the proceeds from exercised options and restricted shares are assumed to be used to purchase common shares at the average market price during the respective periods. The weighted average common shares outstanding used in computing basic earnings per common share for the three months ended September 30, 2018 and 2017 were 67,635,058 and 66,140,518 shares, respectively. The weighted average common shares outstanding used in computing basic earnings per common share for the nine months ended September 30, 2018 and 2017 were 67,586,843 and 66,104,914 shares, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the three months ended September 30, 2018 and 2017 were 68,053,724 and 66,417,281 shares, respectively. The weighted average common shares outstanding used in computing fully diluted earnings per common share for the nine months ended September 30, 2018 and 2017 were 67,948,420 and 66,392,210 shares, respectively. For the three and nine months ended September 30, 2018 and 2017, there were no weighted average outstanding stock options that were anti-dilutive that have been excluded from the earnings per share calculation.

### **Note 4 - Interest-bearing Time Deposits in Banks and Securities**

Interest-bearing time deposits in banks totaled \$1,458,000 at September 30, 2018 and 2017 and December 31, 2017, respectively, and have original maturities within twelve months.

Management classifies debt and equity securities as held-to-maturity, available-for-sale, or trading based on its intent. Debt securities that management has the positive intent and ability to hold to maturity are classified as held-to-maturity and recorded at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income using the interest method. Securities not classified as held-to-maturity or trading are classified as available-for-sale and recorded at fair value, with all unrealized gains and unrealized losses judged to be temporary, net of deferred income taxes, excluded from earnings and reported in the consolidated statements of comprehensive earnings. Available-for-sale securities that have unrealized losses that are judged other-than-temporary are included in gain (loss) on sale of securities and a new cost basis is established. Securities classified as trading are recorded at fair value with unrealized gains and losses included in earnings.

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The Company records its available-for-sale and trading securities portfolio at fair value. Fair values of these securities are determined based on methodologies in accordance with current authoritative accounting guidance. Fair values are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates, credit ratings and yield curves. Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments or an estimate of fair value by using a range of fair value estimates in the market place as a result of the illiquid market specific to the type of security.

When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair value is below amortized cost, additional analysis is performed to determine whether an other-than-temporary impairment condition exists. Available-for-sale and held-to-maturity securities are analyzed quarterly for possible other-than-temporary impairment. The analysis considers (i) whether we have the intent to sell our securities prior to recovery and/or maturity, (ii) whether it is more likely than not that we will have to sell our securities prior to recovery and/or maturity, (iii) the length of time and extent to which the fair value has been less than amortized cost, and (iv) the financial condition of the issuer. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company's results of operations and financial condition.

The Company's investment portfolio consists of U.S. Treasury securities, obligations of U.S. government sponsored enterprises and agencies, obligations of states and political subdivisions, mortgage pass-through securities, corporate bonds and general obligation or revenue based municipal bonds. Pricing for such securities is generally readily available and transparent in the market. The Company utilizes independent third-party pricing services to value its investment securities, which the Company reviews as well as the underlying pricing methodologies for reasonableness and to ensure such prices are aligned with pricing matrices. The Company validates quarterly, on a sample basis, prices supplied by the independent pricing services by comparison to prices obtained from other third-party sources.

A summary of the Company's available-for-sale securities follows (in thousands):

	September 30, 2018			Estimated Fair Value
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
U.S. Treasury Securities	\$ 9,964	\$ —	\$ (35)	\$ 9,929
Obligations of U.S. government sponsored enterprises and agencies	303	—	(1)	302
Obligations of states and political subdivisions	1,174,320	21,664	(4,097)	1,191,887
Corporate bonds and other	4,860	—	(121)	4,739
Residential mortgage-backed securities	1,533,302	912	(39,908)	1,494,306
Commercial mortgage-backed securities	453,495	8	(10,299)	443,204
Total securities available-for-sale	<u>\$3,176,244</u>	<u>\$ 22,584</u>	<u>\$ (54,461)</u>	<u>\$3,144,367</u>

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	September 30, 2017			
	Amortized Cost Basis	Gross		Estimated Fair Value
		Unrealized Holding Gains	Unrealized Holding Losses	
Obligations of U.S. government sponsored enterprises and agencies	\$ 73,583	\$ 35	\$ (30)	\$ 73,588
Obligations of states and political subdivisions	1,379,117	56,671	(1,594)	1,434,194
Corporate bonds and other	19,439	118	(2)	19,555
Residential mortgage-backed securities	1,024,615	8,466	(3,797)	1,029,284
Commercial mortgage-backed securities	328,806	945	(889)	328,862
Total securities available-for-sale	<u>\$2,825,560</u>	<u>\$ 66,235</u>	<u>\$ (6,312)</u>	<u>\$2,885,483</u>

	December 31, 2017			
	Amortized Cost Basis	Gross		Estimated Fair Value
		Unrealized Holding Gains	Unrealized Holding Losses	
Obligations of U.S. government sponsored enterprises and agencies	\$ 60,516	\$ —	\$ (186)	\$ 60,330
Obligations of states and political subdivisions	1,369,295	52,491	(936)	1,420,850
Corporate bonds and other	11,421	43	(5)	11,459
Residential mortgage-backed securities	1,223,452	4,561	(8,916)	1,219,097
Commercial mortgage-backed securities	377,934	263	(2,460)	375,737
Total securities available-for-sale	<u>\$3,042,618</u>	<u>\$ 57,358</u>	<u>\$ (12,503)</u>	<u>\$3,087,473</u>

The Company invests in mortgage-backed securities that have expected maturities that differ from their contractual maturities. These differences arise because borrowers may have the right to call or prepay obligations with or without a prepayment penalty. These securities include collateralized mortgage obligations (CMOs) and other asset backed securities. The expected maturities of these securities at September 30, 2018 were computed by using scheduled amortization of balances and historical prepayment rates. At September 30, 2018 and 2017, and December 31, 2017, the Company did not hold CMOs that entail higher risks than standard mortgage-backed securities.

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The amortized cost and estimated fair value of available-for-sale securities at September 30, 2018, by contractual and expected maturity, are shown below (in thousands):

	Amortized Cost Basis	Estimated Fair Value
Due within one year	\$ 187,577	\$ 189,177
Due after one year through five years	552,075	565,059
Due after five years through ten years	448,087	450,670
Due after ten years	1,708	1,951
Mortgage-backed securities	<u>1,986,797</u>	<u>1,937,510</u>
Total	<u>\$3,176,244</u>	<u>\$3,144,367</u>

The following tables disclose the Company's investment securities that have been in a continuous unrealized-loss position for less than 12 months and for 12 or more months (in thousands):

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>September 30, 2018</b>						
U.S. Treasury Securities	\$ 9,929	\$ 35	\$ —	\$ —	\$ 9,929	\$ 35
Obligations of U.S. government sponsored enterprises and agencies	302	1	—	—	302	1
Obligations of states and political subdivisions	184,265	2,165	44,750	1,932	229,015	4,097
Corporate bonds and other	4,399	110	449	11	4,848	121
Residential mortgage-backed securities	962,320	20,850	461,227	19,058	1,423,547	39,908
Commercial mortgage-backed securities	270,375	5,908	167,368	4,391	437,743	10,299
Total	<u>\$1,431,590</u>	<u>\$ 29,069</u>	<u>\$ 673,794</u>	<u>\$ 25,392</u>	<u>\$2,105,384</u>	<u>\$ 54,461</u>

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>September 30, 2017</b>						
Obligations of U.S. government sponsored enterprises and agencies	\$ 45,050	\$ 30	\$ —	\$ —	\$ 45,050	\$ 30
Obligations of states and political subdivisions	54,983	309	45,217	1,285	100,200	1,594
Corporate bonds and other	—	—	240	2	240	2
Residential mortgage-backed securities	225,369	1,531	131,849	2,266	357,218	3,797
Commercial mortgage-backed securities	170,146	751	21,001	138	191,147	889
Total	<u>\$ 495,548</u>	<u>\$ 2,621</u>	<u>\$ 198,307</u>	<u>\$ 3,691</u>	<u>\$ 693,855</u>	<u>\$ 6,312</u>

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	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b>December 31, 2017</b>						
Obligations of U.S. government sponsored enterprises and agencies	\$ 60,329	\$ 186	\$ —	\$ —	\$ 60,329	\$ 186
Obligations of state and political subdivisions	66,361	219	44,938	717	111,299	936
Corporate bonds and other	224	2	237	3	461	5
Residential mortgage-backed securities	701,252	3,988	239,641	4,928	940,893	8,916
Commercial mortgage-backed securities	239,548	1,500	92,549	960	332,097	2,460
Total	<u>\$1,067,714</u>	<u>\$ 5,895</u>	<u>\$377,365</u>	<u>\$ 6,608</u>	<u>\$1,445,079</u>	<u>\$ 12,503</u>

The number of investments in an unrealized loss position totaled 484 at September 30, 2018. We do not believe these unrealized losses are “other-than-temporary” as (i) we do not have the intent to sell our securities prior to recovery and/or maturity and (ii) it is more likely than not that we will not have to sell our securities prior to recovery and/or maturity. In making this determination, we also consider the length of time and extent to which fair value has been less than cost and the financial condition of the issuer. The unrealized losses noted are interest rate related due to the level of interest rates at September 30, 2018 compared to the time of purchase. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies. At September 30, 2018, 83.26% of our available-for-sale securities that are obligations of states and political subdivisions were issued within the State of Texas, of which 31.30% are guaranteed by the Texas Permanent School Fund.

At September 30, 2018, \$1,820,197,000 of the Company’s securities were pledged as collateral for public or trust fund deposits, repurchase agreements and for other purposes required or permitted by law.

During the quarters ended September 30, 2018 and 2017, sales of investment securities that were classified as available-for-sale totaled \$71,134,000 and \$83,605,000, respectively. Gross realized gains from security sales during the third quarter of 2018 and 2017 totaled \$348,000 and \$1,750,000, respectively. Gross realized losses from security sales during the third quarter of 2018 and 2017 totaled \$290,000 and \$675,000, respectively. During the nine months ended September 30, 2018 and 2017, sale of investment securities were classified as available-for-sale totaled \$220,259,000 and \$120,576,000, respectively. Gross realized gains from security sales during the nine-month period ended September 30, 2018 and 2017 totaled \$1,877,000 and totaled \$2,550,000, respectively. Gross realized losses from security sales during the nine-month periods ended September 30, 2018 and 2017 totaled \$531,000 and \$725,000, respectively.

The specific identification method was used to determine cost in order to compute the realized gains and losses.

### **Note 5 – Loans Held for Investment and Allowance for Loan Losses**

Loans held for investment are stated at the amount of unpaid principal, reduced by unearned income and an allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amounts outstanding. The Company defers and amortizes net loan origination fees and costs as an adjustment to yield. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely.



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The Company has certain lending policies and procedures in place that are designed to maximize loan income with an acceptable level of risk. Management reviews and approves these policies and procedures on an annual basis and makes changes as appropriate. Management receives and reviews monthly reports related to loan originations, quality, concentrations, delinquencies, nonperforming and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions, both by type of loan and geographic location.

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and effectively. Underwriting standards are designed to determine whether the borrower possesses sound business ethics and practices and to evaluate current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and, secondarily, on the underlying collateral provided by the borrower. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and include personal guarantees.

Agricultural loans are subject to underwriting standards and processes similar to commercial loans. These agricultural loans are based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. Most agricultural loans are secured by the agriculture related assets being financed, such as farm land, cattle or equipment, and include personal guarantees.

Real estate loans are also subject to underwriting standards and processes similar to commercial and agricultural loans. These loans are underwritten primarily based on projected cash flows and, secondarily, as loans secured by real estate. The repayment of real estate loans is generally largely dependent on the successful operation of the property securing the loans or the business conducted on the property securing the loan. Real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's real estate portfolio are generally diverse in terms of type and geographic location within Texas. This diversity helps reduce the exposure to adverse economic events that affect any single market or industry. Generally, real estate loans are owner occupied which further reduces the Company's risk.

Consumer loan underwriting utilizes methodical credit standards and analysis to supplement the Company's underwriting policies and procedures. The Company's loan policy addresses types of consumer loans that may be originated and the collateral, if secured, which must be perfected. The relatively smaller individual dollar amounts of consumer loans that are spread over numerous individual borrowers also minimize the Company's risk.

The allowance for loan losses is an amount which represents management's best estimate of probable losses that are inherent in the Company's loan portfolio as of the balance sheet date. The allowance for loan losses is comprised of three elements: (i) specific reserves determined based on probable losses on specific classified loans; (ii) a historical valuation reserve component that considers historical loss rates; and (iii) qualitative reserves based upon general economic conditions and other qualitative risk factors both internal and external to the Company. The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Management's periodic evaluation of the appropriateness of the allowance is based on general economic conditions, the financial condition of borrowers, the value and liquidity of collateral, delinquency, prior loan loss experience, and the results of periodic reviews of the portfolio. For purposes of determining our historical valuation reserve, the loan portfolio, less cash secured loans, government guaranteed loans and classified loans, is multiplied by the Company's historical loss rate. Specific allocations are increased or decreased in accordance with deterioration or improvement in credit quality and a corresponding increase or decrease in risk of loss on a particular loan. In addition, we adjust our allowance for qualitative factors such as current local economic conditions and trends, including, without limitations, unemployment, oil and gas prices, flood and drought conditions, changes in lending staff, policies and procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans. This qualitative reserve serves to estimate for additional areas of losses inherent in our portfolio that are not reflected in our historic loss factors.

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Although we believe we use the best information available to make loan loss allowance determinations, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making our initial determinations. A decline in the economy and employment rates could result in increased levels of non-performing assets and charge-offs, increased loan provisions and reductions in income. Additionally, bank regulatory agencies periodically review our allowance for loan losses and methodology and could require, in accordance with generally accepted accounting principles, additional provisions to the allowance for loan losses based on their judgment of information available to them at the time of their examination as well as changes to our methodology.

Accrual of interest is discontinued on a loan and payments are applied to principal when management believes, after considering economic and business conditions and collection efforts, the borrower's financial condition is such that collection of interest is doubtful. Except consumer loans, generally all loans past due greater than 90 days, based on contractual terms, are placed on non-accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Consumer loans are generally charged-off when a loan becomes past due 90 days. For other loans in the portfolio, facts and circumstances are evaluated in making charge-off decisions.

Loans are considered impaired when, based on current information and events, management determines that it is probable we will be unable to collect all amounts due in accordance with the loan agreement, including scheduled principal and interest payments. If a loan is impaired, a specific valuation allowance is allocated, if necessary. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectable.

The Company's policy requires measurement of the allowance for an impaired, collateral dependent loan based on the fair value of the collateral. Other loan impairments for non-collateral dependent loans are measured based on the present value of expected future cash flows or the loan's observable market price. At September 30, 2018 and 2017, and December 31, 2017, all significant impaired loans have been determined to be collateral dependent and the allowance for loss has been measured utilizing the estimated fair value of the collateral less costs to sell.

From time to time, the Company modifies its loan agreement with a borrower. A modified loan is considered a troubled debt restructuring when two conditions are met: (i) the borrower is experiencing financial difficulty and (ii) concessions are made by the Company that would not otherwise be considered for a borrower with similar credit risk characteristics. Modifications to loan terms may include a lower interest rate, a reduction of principal, or a longer term to maturity. For all impaired loans, including the Company's troubled debt restructurings, the Company performs a periodic, well-documented credit evaluation of the borrower's financial condition and prospects for repayment to assess the likelihood that all principal and interest payments required under the terms of the agreement will be collected in full. When doubt exists about the ultimate collectability of principal and interest, the troubled debt restructuring remains on non-accrual status and payments received are applied to reduce principal to the extent necessary to eliminate such doubt. This determination of accrual status is judgmental and is based on facts and circumstances related to each troubled debt restructuring. Each of these loans is individually evaluated for impairment and a specific reserve is recorded based on probable losses, taking into consideration the related collateral, modified loan terms and cash flow. As of September 30, 2018 and 2017, and December 31, 2017, substantially all of the Company's troubled debt restructured loans are included in the non-accrual totals.

Loans acquired, including loans acquired in a business combination, are initially recorded at fair value with no valuation allowance. Acquired loans are segregated between those considered to be credit impaired and those deemed performing. To make this determination, management considers such factors as past due status, non-accrual status and credit risk ratings. The fair value of acquired performing loans

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is determined by discounting expected cash flows, both principal and interest, at prevailing market interest rates. The difference between the fair value and principal balances at acquisition date, the fair value discount, is accreted into interest income over the estimated life of the acquired performing loan portfolio.

Purchased credit impaired loans are those loans that showed evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all amounts contractually owed. Their acquisition fair value, which includes a credit component at the acquisition date, was based on the estimate of cash flows, both principal and interest, expected to be collected or estimated collateral values if cash flows are not estimable, discounted at prevailing market rates of interest. The difference between the discounted cash flows expected at acquisition and the investment in the loan is recognized as interest income on a level-yield method over the life of the loan, unless management was unable to reasonably forecast cash flows in which case the loans were placed on nonaccrual. Contractually required payments for interest and principal that exceed the cash flows expected at acquisition are not recognized as a yield adjustment. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows subsequent to acquisition are recognized as impairment. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition. The carrying amount of purchased credit impaired loans at September 30, 2018 and 2017, and December 31, 2017, was \$2,947,000, \$736,000 and \$618,000, respectively, compared to a contractual balance of \$3,898,000, \$932,000, and \$755,000, respectively. Other purchased credit impaired loan disclosures were omitted due to immateriality.

Loans held-for-investment by class of financing receivables are as follows (in thousands):

	September 30,		December 31,
	2018	2017	2017
Commercial	\$ 773,924	\$ 674,947	\$ 684,099
Agricultural	93,953	83,005	94,543
Real estate	2,614,929	2,297,556	2,302,998
Consumer	384,234	416,719	403,929
Total loans held-for-investment	<u>\$3,867,040</u>	<u>\$3,472,227</u>	<u>\$ 3,485,569</u>

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The Company's non-accrual loans, loans still accruing and past due 90 days or more and restructured loans are as follows (in thousands):

	September 30,		December 31,
	2018	2017	2017
Non-accrual loans*	\$25,587	\$18,750	\$ 17,670
Loans still accruing and past due 90 days or more	88	257	288
Troubled debt restructured loans**	513	668	627
Total	<u>\$26,188</u>	<u>\$19,675</u>	<u>\$ 18,585</u>

\* Includes \$2,947,000, \$736,000 and \$618,000 of purchased credit impaired loans as of September 30, 2018 and 2017, and December 31, 2017, respectively.

\*\* Troubled debt restructured loans of \$4,577,000, \$5,277,000 and \$4,629,000, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans at September 30, 2018 and 2017, and December 31, 2017, respectively.

The Company's recorded investment in impaired loans and the related valuation allowance are as follows (in thousands):

September 30, 2018		September 30, 2017		December 31, 2017	
Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance
\$ 25,587	\$ 4,988	\$ 18,750	\$ 4,177	\$ 17,670	\$ 3,996

The Company had \$26,859,000, \$22,076,000 and \$20,117,000 in non-accrual, past due 90 days or more and still accruing, restructured loans and foreclosed assets at September 30, 2018 and 2017, and December 31, 2017, respectively. Non-accrual loans at September 30, 2018 and 2017, and December 31, 2017, consisted of the following by class of financing receivables (in thousands):

	September 30,		December 31,
	2018	2017	2017
Commercial	\$ 6,961	\$ 4,133	\$ 3,612
Agricultural	1,046	60	134
Real estate	16,682	13,386	12,838
Consumer	898	1,171	1,086
Total	<u>\$25,587</u>	<u>\$18,750</u>	<u>\$ 17,670</u>

No significant additional funds are committed to be advanced in connection with impaired loans as of September 30, 2018.

The Company's impaired loans and related allowance are summarized in the following tables by class of financing receivables (in thousands). No interest income was recognized on impaired loans subsequent to their classification as impaired.

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September 30, 2018	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance*	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Year –to-Date Average Recorded Investment	Three- Month Average Recorded Investment
Commercial	\$ 9,276	\$ 3,467	\$ 3,494	\$ 6,961	\$ 1,412	\$ 8,339	\$ 7,669
Agricultural	1,062	—	1,046	1,046	528	1,506	1,101
Real Estate	22,513	4,215	12,467	16,682	2,652	18,688	17,762
Consumer	1,088	50	848	898	396	1,012	942
<b>Total</b>	<b>\$ 33,939</b>	<b>\$ 7,732</b>	<b>\$ 17,855</b>	<b>\$ 25,587</b>	<b>\$ 4,988</b>	<b>\$ 29,545</b>	<b>\$ 27,474</b>

\* Includes \$2,947,000 of purchased credit impaired loans.

September 30, 2017	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance*	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Year –to- Date Average Recorded Investment	Three- Month Average Recorded Investment
Commercial	\$ 10,989	\$ 617	\$ 3,516	\$ 4,133	\$ 1,671	\$ 7,313	\$ 5,866
Agricultural	66	—	60	60	17	66	60
Real Estate	17,306	3,742	9,644	13,386	1,984	14,279	13,829
Consumer	1,388	262	909	1,171	505	1,341	1,238
<b>Total</b>	<b>\$ 29,749</b>	<b>\$ 4,621</b>	<b>\$ 14,129</b>	<b>\$ 18,750</b>	<b>\$ 4,177</b>	<b>\$ 22,999</b>	<b>\$ 20,993</b>

\* Includes \$736,000 of purchased credit impaired loans.

December 31, 2017	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance*	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	12 Month Average Recorded Investment
Commercial	\$ 5,597	\$ 518	\$ 3,094	\$ 3,612	\$ 1,194	\$ 4,849
Agricultural	147	—	134	134	31	120
Real Estate	16,823	2,348	10,490	12,838	2,316	13,835
Consumer	1,284	143	943	1,086	455	1,258
<b>Total</b>	<b>\$ 23,851</b>	<b>\$ 3,009</b>	<b>\$ 14,661</b>	<b>\$ 17,670</b>	<b>\$ 3,996</b>	<b>\$ 20,062</b>

\* Includes \$618,000 of purchased credit impaired loans.

The Company recognized interest income on impaired loans prior to being recognized as impaired of approximately \$624,000 during the year ended December 31, 2017. Such amounts for the three-month and nine-month periods ended September 30, 2018 and 2017 were not significant.

From a credit risk standpoint, the Company rates its loans in one of four categories: (i) pass, (ii) special mention, (iii) substandard or (iv) doubtful. Loans rated as loss are charged-off.

The ratings of loans reflect a judgment about the risks of default and loss associated with the loan. The Company reviews the ratings on our credits as part of our on-going monitoring of the credit quality of our loan portfolio. Ratings are adjusted to reflect the degree of risk and loss that are felt to be inherent in each credit as of each reporting period. Our methodology is structured so that specific allocations are increased in accordance with deterioration in credit quality (and a corresponding increase in risk and loss) or decreased in accordance with improvement in credit quality (and a corresponding decrease in risk and loss).

Credits rated special mention show clear signs of financial weaknesses or deterioration in credit worthiness, however, such concerns are not so pronounced that the Company generally expects to experience significant loss within the short-term. Such credits typically maintain the ability to perform within standard credit terms and credit exposure is not as prominent as credits rated more harshly.

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Credits rated substandard are those in which the normal repayment of principal and interest may be, or has been, jeopardized by reason of adverse trends or developments of a financial, managerial, economic or political nature, or important weaknesses exist in collateral. A protracted workout on these credits is a distinct possibility. Prompt corrective action is therefore required to strengthen the Company's position, and/or to reduce exposure and to assure that adequate remedial measures are taken by the borrower. Credit exposure becomes more likely in such credits and a serious evaluation of the secondary support to the credit is performed.

Credits rated doubtful are those in which full collection of principal appears highly questionable, and which some degree of loss is anticipated, even though the ultimate amount of loss may not yet be certain and/or other factors exist which could affect collection of debt. Based upon available information, positive action by the Company is required to avert or minimize loss. Credits rated doubtful are generally also placed on non-accrual.

The following summarizes the Company's internal ratings of its loans held-for-investment by class of financing receivables and portfolio segments, which are the same (in thousands):

September 30, 2018	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 747,758	\$ 8,817	\$ 17,349	\$ —	\$ 773,924
Agricultural	89,314	68	4,571	—	93,953
Real Estate	2,530,673	27,241	57,015	—	2,614,929
Consumer	381,772	324	2,138	—	384,234
<b>Total</b>	<b>\$3,749,517</b>	<b>\$36,450</b>	<b>\$ 81,073</b>	<b>\$ —</b>	<b>\$3,867,040</b>

September 30, 2017	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 632,693	\$ 7,997	\$ 34,257	\$ —	\$ 674,947
Agricultural	79,227	841	2,937	—	83,005
Real Estate	2,224,970	26,231	46,355	—	2,297,556
Consumer	414,043	168	2,508	—	416,719
<b>Total</b>	<b>\$3,350,933</b>	<b>\$35,237</b>	<b>\$ 86,057</b>	<b>\$ —</b>	<b>\$3,472,227</b>

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 649,166	\$ 6,282	\$ 28,651	\$ —	\$ 684,099
Agricultural	90,457	1,527	2,559	—	94,543
Real Estate	2,227,302	29,089	46,607	—	2,302,998
Consumer	401,434	181	2,314	—	403,929
<b>Total</b>	<b>\$3,368,359</b>	<b>\$37,079</b>	<b>\$ 80,131</b>	<b>\$ —</b>	<b>\$3,485,569</b>

The Company's past due loans are as follows (in thousands):

September 30, 2018	15-59 Days Past Due*	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	90 Days Past Due Still Accruing
Commercial	\$ 3,850	\$ 420	\$3,331	\$ 7,601	\$ 766,323	\$ 773,924	\$ —
Agricultural	442	—	287	729	93,224	93,953	—
Real Estate	15,542	2,583	661	18,786	2,596,143	2,614,929	—
Consumer	749	173	145	1,067	383,167	384,234	88
<b>Total</b>	<b>\$20,583</b>	<b>\$3,176</b>	<b>\$4,424</b>	<b>\$28,183</b>	<b>\$3,838,857</b>	<b>\$3,867,040</b>	<b>\$ 88</b>

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September 30, 2017	15-59 Days Past Due*	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	90 Days Past Due Still Accruing
Commercial	\$ 3,288	\$ 585	\$ 1,495	\$ 5,368	\$ 669,579	\$ 674,947	\$ 212
Agricultural	322	—	—	322	82,683	83,005	—
Real Estate	12,636	984	2,293	15,913	2,281,643	2,297,556	—
Consumer	1,211	457	176	1,844	414,875	416,719	45
Total	<u>\$17,457</u>	<u>\$2,026</u>	<u>\$3,964</u>	<u>\$23,447</u>	<u>\$3,448,780</u>	<u>\$3,472,227</u>	<u>\$ 257</u>

December 31, 2017	15-59 Days Past Due*	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Total Current	Total Loans	Total 90 Days Past Due Still Accruing
Commercial	\$ 2,039	\$1,104	\$1,081	\$ 4,224	\$ 679,875	\$ 684,099	\$ 7
Agricultural	640	—	—	640	93,903	94,543	—
Real Estate	12,308	511	1,198	14,017	2,288,981	2,302,998	216
Consumer	1,360	361	135	1,856	402,073	403,929	65
Total	<u>\$16,347</u>	<u>\$1,976</u>	<u>\$2,414</u>	<u>\$20,737</u>	<u>\$3,464,832</u>	<u>\$3,485,569</u>	<u>\$ 288</u>

\* The Company monitors commercial, agricultural and real estate loans after such loans are 15 days past due. Consumer loans are monitored after such loans are 30 days past due.

The following table details the allowance for loan losses by portfolio segment (in thousands). There were no allowances for purchased credit impaired loans at September 30, 2018 and 2017, and December 31, 2017. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

September 30, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 1,412	\$ 528	\$ 2,652	\$ 396	\$ 4,988
Loans collectively evaluated for impairment	7,549	1,106	31,713	5,515	45,883
Total	<u>\$ 8,961</u>	<u>\$ 1,634</u>	<u>\$ 34,365</u>	<u>\$ 5,911</u>	<u>\$50,871</u>

September 30, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 1,671	\$ 17	\$ 1,984	\$ 505	\$ 4,177
Loans collectively evaluated for impairment	10,201	1,284	26,484	5,776	43,745
Total	<u>\$ 11,872</u>	<u>\$ 1,301</u>	<u>\$ 28,468</u>	<u>\$ 6,281</u>	<u>\$47,922</u>

December 31, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 1,194	\$ 31	\$ 2,316	\$ 455	\$ 3,996
Loans collectively evaluated for impairment	9,671	1,274	27,580	5,635	44,160
Total	<u>\$ 10,865</u>	<u>\$ 1,305</u>	<u>\$ 29,896</u>	<u>\$ 6,090</u>	<u>\$48,156</u>

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Changes in the allowance for loan losses are summarized as follows by portfolio segment (in thousands):

Three months ended September 30, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	\$ 9,218	\$ 1,402	\$ 33,243	\$ 6,088	\$49,951
Provision for loan losses	(24)	229	1,091	154	1,450
Recoveries	192	3	85	135	415
Charge-offs	(425)	—	(54)	(466)	(945)
Ending balance	<u>\$ 8,961</u>	<u>\$ 1,634</u>	<u>\$ 34,365</u>	<u>\$ 5,911</u>	<u>\$50,871</u>

Three months ended September 30, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	\$ 11,935	\$ 1,127	\$ 28,023	\$ 6,325	\$47,410
Provision for loan losses	557	157	424	277	1,415
Recoveries	119	17	50	91	277
Charge-offs	(739)	—	(29)	(412)	(1,180)
Ending balance	<u>\$ 11,872</u>	<u>\$ 1,301</u>	<u>\$ 28,468</u>	<u>\$ 6,281</u>	<u>\$47,922</u>

Nine months ended September 30, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	\$ 10,865	\$ 1,305	\$ 29,896	\$ 6,090	\$48,156
Provision for loan losses	(1,316)	317	4,325	539	3,865
Recoveries	476	12	345	382	1,215
Charge-offs	(1,064)	—	(201)	(1,100)	(2,365)
Ending balance	<u>\$ 8,961</u>	<u>\$ 1,634</u>	<u>\$ 34,365</u>	<u>\$ 5,911</u>	<u>\$50,871</u>

Nine months ended September 30, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Beginning balance	\$ 11,707	\$ 1,101	\$ 26,864	\$ 6,107	\$45,779
Provision for loan losses	1,485	211	2,556	838	5,090
Recoveries	868	25	141	400	1,434
Charge-offs	(2,188)	(36)	(1,093)	(1,064)	(4,381)
Ending balance	<u>\$ 11,872</u>	<u>\$ 1,301</u>	<u>\$ 28,468</u>	<u>\$ 6,281</u>	<u>\$47,922</u>

The Company's recorded investment in loans related to the balance in the allowance for loan losses on the basis of the Company's impairment methodology is as follows (in thousands). Purchased credit impaired loans of \$2,947,000, \$736,000 and \$618,000 at September 30, 2018 and 2017, and December 31, 2017, respectively, are included in loans individually evaluated for impairment.

September 30, 2018	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 6,961	\$ 1,046	\$ 16,682	\$ 898	\$ 25,587
Loans collectively evaluated for impairment	766,963	92,907	2,598,247	383,336	3,841,453
Total	<u>\$ 773,924</u>	<u>\$ 93,953</u>	<u>\$2,614,929</u>	<u>\$384,234</u>	<u>\$3,867,040</u>

September 30, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 4,133	\$ 60	\$ 13,386	\$ 1,171	\$ 18,750
Loans collectively evaluated for impairment	670,814	82,945	2,284,170	415,548	3,453,477
Total	<u>\$ 674,947</u>	<u>\$ 83,005</u>	<u>\$2,297,556</u>	<u>\$416,719</u>	<u>\$3,472,227</u>

December 31, 2017	Commercial	Agricultural	Real Estate	Consumer	Total
Loans individually evaluated for impairment	\$ 3,612	\$ 134	\$ 12,838	\$ 1,086	\$ 17,670
Loans collectively evaluated for impairment	680,487	94,409	2,290,160	402,843	3,467,899
Total	<u>\$ 684,099</u>	<u>\$ 94,543</u>	<u>\$2,302,998</u>	<u>\$403,929</u>	<u>\$3,485,569</u>



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The Company's loans that were modified and considered troubled debt restructurings are as follows (in thousands):

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	2	\$ 547	\$ 547	3	\$ 826	\$ 826
Agricultural	—	—	—	1	4	4
Real Estate	1	117	117	5	642	642
Consumer	—	—	—	6	113	113
<b>Total</b>	<b>3</b>	<b>\$ 664</b>	<b>\$ 664</b>	<b>15</b>	<b>\$ 1,585</b>	<b>\$ 1,585</b>

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	3	\$ 514	\$ 514	9	\$ 838	\$ 838
Agricultural	—	—	—	—	—	—
Real Estate	1	256	256	3	473	473
Consumer	—	—	—	1	25	25
<b>Total</b>	<b>4</b>	<b>\$ 770</b>	<b>\$ 770</b>	<b>13</b>	<b>\$ 1,336</b>	<b>\$ 1,336</b>

The balances below provide information as to how the loans were modified as troubled debt restructured loans (in thousands):

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity
Commercial	\$ —	\$ 491	\$ 56	—	\$ 491	\$ 335
Agricultural	—	—	—	—	—	4
Real Estate	—	117	—	—	279	363
Consumer	—	—	—	—	—	113
<b>Total</b>	<b>\$ —</b>	<b>\$ 608</b>	<b>\$ 56</b>	<b>—</b>	<b>\$ 770</b>	<b>\$ 815</b>

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity	Adjusted Interest Rate	Extended Maturity	Combined Rate and Maturity
Commercial	\$ —	\$ —	\$ 514	—	\$ 181	\$ 657
Agricultural	—	—	—	—	—	—
Real Estate	—	256	—	—	312	161
Consumer	—	—	—	—	25	—
<b>Total</b>	<b>\$ —</b>	<b>\$ 256</b>	<b>\$ 514</b>	<b>—</b>	<b>\$ 518</b>	<b>\$ 818</b>

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During the three and nine months ended September 30, 2018, no loans were modified as a troubled debt restructured loan within the previous 12 months and for which there was a payment default. During the three and nine months ended September 30, 2017, two loans and four loans, respectively, were modified as a troubled debt restructured loan within the previous 12 months and for which there was a payment default. A default for purposes of this disclosure is a troubled debt restructured loan in which the borrower is 90 days past due or more or results in the foreclosure and repossession of the applicable collateral. The loans with payment default are as follows (dollars in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	Number	Balance	Number	Balance
Commercial	—	\$ —	—	\$ —
Agriculture	—	—	—	—
Real Estate	—	—	—	—
Consumer	—	—	—	—
Total	—	\$ —	—	\$ —

  

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
	Number	Balance	Number	Balance
Commercial	2	\$ 88	3	\$ 141
Agriculture	—	—	—	—
Real Estate	—	—	1	62
Consumer	—	—	—	—
Total	2	\$ 88	4	\$ 203

As of September 30, 2018, the Company has no commitments to lend additional funds to loan customers whose terms have been modified in troubled debt restructurings.

Our subsidiary bank has established a line of credit with the Federal Home Loan Bank of Dallas (FHLB) to provide liquidity and meet pledging requirements for those customers eligible to have securities pledged to secure certain uninsured deposits. At September 30, 2018, \$2,450,523,000 in loans held by our bank subsidiary were subject to blanket liens as security for this line of credit. At September 30, 2018, there were no advances or letters of credit outstanding under this line of credit.

### **Note 6 - Loans Held for Sale**

The Company originates certain mortgage loans for sale in the secondary market. The mortgage loan sales contracts contain indemnification clauses should the loans default, generally in the first three to nine months, or if documentation is determined not to be in compliance with regulations. The Company's historic losses as a result of these indemnities have been insignificant.

Loans held for sale totaled \$18,496,000, \$19,119,000 and \$15,130,000 at September 30, 2018 and 2017, and December 31, 2017, respectively. At September 30, 2018, \$2,541,000 is valued at the lower of cost or fair value, and the remaining amount is valued under the fair value option. All of the amounts for December 31, 2017 and September 30, 2017 were valued at the lower of cost or fair value. The change to the fair value option for loans held for sale was effective at June 30, 2018 and was done in conjunction with the Company's move to mandatory delivery in the secondary market and the purchase of forward mortgage-backed securities to manage the changes in fair value (see note 7 for additional information).

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These loans, which are sold on a servicing released basis, are valued using a market approach by utilizing either: (i) the fair value of the securities backed by similar mortgage loans, adjusted for certain factors to approximate the fair value of a whole mortgage loan, including the value attributable to mortgage servicing and credit risk, (ii) current commitments to purchase loans or (iii) recent observable market trades for similar loans, adjusted for credit risk and other individual loan characteristics. As these prices are derived from market observable inputs, the Company classifies these valuations as Level 2 in the fair value disclosures (see note 12). Interest income on mortgage loans held for sale is recognized based on the contractual rates and reflected in interest income on loans in the consolidated statements of earnings. The Company has no continuing ownership in any residential mortgage loans sold.

### **Note 7 - Derivative Financial Instruments**

The Company enters into interest rate lock commitments (“IRLCs”) with customers to originate residential mortgage loans at a specific interest rate that are ultimately sold in the secondary market. These commitments, which contain fixed expiration dates, offer the borrower an interest rate guarantee provided the loan meets underwriting guidelines and closes within the timeframe established by the Company.

Beginning in the second quarter of 2018, the Company purchased forward mortgage-backed securities contracts to manage the changes in fair value associated with changes in interest rates related to a portion of the IRLCs. These instruments are typically entered into at the time the IRLC is made.

These financial instruments are not designated as hedging instruments and are used for asset and liability management needs. All derivatives are carried at fair value in either other assets or other liabilities.

The fair values of IRLCs are based on current secondary market prices for underlying loans and estimated servicing value with similar coupons, maturity and credit quality, subject to the anticipated loan funding probability (pull-through rate). The fair value of IRLCs is subject to change primarily due to changes in interest rates and the estimated pull-through rate. These commitments are classified as Level 3 in the fair value disclosures (see note 12), as the valuations are based on observable market inputs.

Forward mortgage-backed securities contracts are exchange-traded or traded within highly active dealer markets. In order to determine the fair value of these instruments, the Company utilizes the exchange price or dealer market price for the particular derivative contract and these instruments are therefore classified as Level 2 in the fair value disclosures (see note 12). The estimated fair values are subject to change primarily due to changes in interest rates.

The following table provides the outstanding notional balances and fair values of outstanding derivative positions (dollars in thousands):

	Outstanding Notional Balance	Asset Derivative Fair Value	Liability Derivative Fair Value
<b>September 30, 2018:</b>			
IRLCs	\$ 48,311	\$ 715	\$ —
Forward mortgage-backed securities trades	42,500	143	—
	Outstanding Notional Balance	Asset Derivative Fair Value	Liability Derivative Fair Value
<b>September 30, 2017:</b>			
IRLCs	\$ 53,911	\$ 440	\$ —

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	Outstanding Notional Balance	Asset Derivative Fair Value	Liability Derivative Fair Value
<b>December 31, 2017:</b>			
IRLCs	\$ 37,589	\$ 500	\$ —

### **Note 8 – Borrowings**

Borrowings consisted of the following (dollars in thousands):

	September 30,		December 31,
	2018	2017	2017
Securities sold under agreements with customers to repurchase	\$378,460	\$339,660	\$ 320,450
Federal funds purchased	2,300	11,775	10,550
<b>Total</b>	<b>\$380,760</b>	<b>\$351,435</b>	<b>\$ 331,000</b>

Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which the Company pledges certain securities that have a fair value equal to at least the amount of the borrowings. The agreements mature daily and therefore the risk arising from a decline in the fair value of the collateral pledged is minimal. The securities pledged are mortgage-backed securities. These agreements do not include “right of set-off” provisions and therefore the Company does not offset such agreements for financial reporting purposes.

### **Note 9 - Income Taxes**

Income tax expense was \$7,475,000 for the third quarter of 2018 as compared to \$9,195,000 for the same period in 2017. The Company’s effective tax rates on pretax income were 15.73% and 23.84% for the third quarters of 2018 and 2017, respectively. Income tax expense was \$20,937,000 for the nine months ended September 30, 2018 as compared to \$25,300,000 for the same period in 2017. The Company’s effective tax rates on pretax income were 15.73% and 23.10% for the nine months ended September 30, 2018 and 2017, respectively. The effective tax rates differ from the statutory federal tax rate of 21% for 2018 and 35% for 2017 primarily due to tax exempt interest income earned on certain investment securities and loans, the deductibility of dividends paid to our employee stock ownership plan and excess tax benefits related to our directors’ deferred compensation plan.

On December 22, 2017, the Tax Cuts and Jobs Act (“Jobs Act”) was signed into law with sweeping modifications to the Internal Revenue Service Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company’s deferred tax assets and liabilities were re-measured based on the income tax rules at which they are expected to reverse in the future, which is now generally 21%. The Company continues to analyze certain aspects of the Jobs Act resulting in refinement of the calculations which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the re-measurement of the Company’s deferred tax balance was \$7,650,000, and was recorded in December 2017 as a reduction of income tax expense. There have been no adjustments to this provisional amount recorded in the three months and nine months ended September 30, 2018. In addition, income tax rate changes in deferred tax assets and liabilities totaling \$5,759,000 related to amounts recorded in accumulated other comprehensive income were reclassified from accumulated other comprehensive income to retained earnings during the first quarter of 2018.

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### **Note 10 - Stock Option Plan and Restricted Stock Plan**

The Company grants incentive stock options for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant to employees. In June 2017, the Company granted 452,450 incentive stock options with an exercise price of \$42.35 per share. The fair value of the options was \$9.90 per option and was estimated using the Black-Scholes options pricing model with the following weighted average assumptions: risk-free interest rate of 1.89%; expected dividend yield of 1.79%; expected life of 6.24 years; and expected volatility of 26.51%. No options have been granted in 2018.

The Company recorded stock option expense totaling \$377,000 and \$750,000 for the three-month periods ended September 30, 2018 and 2017, respectively. The Company recorded stock option expense totaling \$1,131,000 and \$1,182,000 for the nine months ended September 30, 2018 and 2017, respectively. The additional disclosure requirements under authoritative accounting guidance have been omitted due to the amounts being insignificant.

On April 26, 2016, upon re-election of existing directors, 7,660 restricted shares with a total value of \$250,000 were granted to the ten non-employee directors and was expensed over the period from grant date to April 25, 2017, the date of the next Annual Shareholders' Meeting at which these directors' term expired. On April 25, 2017, upon re-election of existing directors, 14,650 restricted shares with a total value of \$600,000 were granted to the ten non-employee directors and was expensed over the period from the grant date to April 24, 2018, the date of the next Annual Shareholders' Meeting at which these directors' term expired. On April 24, 2018, upon re-election of nine of the existing directors, 10,710 restricted shares with a total value of \$540,000 were granted to these non-employee directors and is being expensed over the period from grant date to April 23, 2019, the Company's next shareholders' meeting at which the director's term expires. The Company recorded director expense related to these restricted share grants of \$135,000 and \$150,000 for the three-month periods ended September 30, 2018 and 2017, respectively. The Company recorded director expense related to these restricted stock grants of \$425,000 and \$333,000 for the nine months period ended September 30, 2018 and 2017, respectively.

On October 27, 2015, the Company granted 31,273 restricted shares with a total value of \$1,060,000 to certain officers that is being expensed over the vesting period of three years. On October 25, 2016, the Company granted 15,405 restricted stock shares with a total value of \$560,000 to certain officers that is being expensed over the vesting period of three years. On October 24, 2017, the Company granted 14,191 restricted shares with a total value of \$655,000 to certain officers that is being expensed over the vesting period of one to three years. The Company recorded restricted stock expense for officers of \$175,000 and \$133,000, for the three-month periods ended September 30, 2018 and 2017, respectively. The Company recorded restricted stock expense for officers of \$501,000 and \$399,000, for the nine-month periods ended September 30, 2018 and 2017, respectively.

On October 23, 2018, the Company granted 26,021 restricted shares with a total value of \$1,440,000 to certain officers that will be expensed over a three year vesting period.

### **Note 11 - Pension Plan**

The Company's defined benefit pension plan was frozen effective January 1, 2004, whereby no new participants will be added to the plan and no additional years of service will accrue to participants, unless the pension plan is reinstated at a future date. The pension plan covered substantially all of the Company's employees at the time. The benefits for each employee were based on years of service and a percentage of the employee's qualifying compensation during the final years of employment. The Company's funding policy was and is to contribute annually the amount necessary to satisfy the Internal Revenue Service's funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of the Pension Protection Act of 2006 (the "Protection Act"), the Company will be required to contribute amounts in future years to fund any shortfalls. The Company has evaluated the provisions of the Protection Act as well as the Internal Revenue Service's funding standards to develop a plan for funding in future years. The Company made no contribution in 2017, and has not made a contribution through September 30, 2018.

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Net periodic benefit costs totaling \$65,000 and \$84,000 were recorded for the three months ended September 30, 2018 and 2017, respectively. Net periodic benefit costs totaling \$177,000 and \$253,000 were recorded for the nine months ended September 30, 2018 and 2017, respectively.

### **Note 12 - Fair Value Disclosures**

The authoritative accounting guidance for fair value measurements defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact.

The authoritative accounting guidance requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, the authoritative guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- Level 1 Inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 Inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 Inputs – Significant unobservable inputs that reflect an entity's own assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs,

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observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Securities classified as available-for-sale and trading are reported at fair value utilizing Level 1 and Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include market spreads, cash flows, the United States Treasury yield curve, live trading levels, trade execution data, dealer quotes, market consensus prepayments speeds, credit information and the security's terms and conditions, among other items.

There were no transfers between Level 1 and Level 2 or Level 2 and Level 3 during the nine months ended September 30, 2018 and 2017, and the year ended December 31, 2017.

The following table summarizes the Company's available-for-sale securities which are measured at fair value on a recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
<b>September 30, 2018</b>				
Available-for-sale investment securities:				
U.S. Treasury securities	\$ 9,929	\$ —	\$ —	\$ 9,929
Obligations of U. S. government sponsored enterprises and agencies	—	302	—	302
Obligations of states and political subdivisions	—	1,191,887	—	1,191,887
Corporate bonds	—	450	—	450
Residential mortgage-backed securities	—	1,494,306	—	1,494,306
Commercial mortgage-backed securities	—	443,204	—	443,204
Other securities	4,289	—	—	4,289
Total	<u>\$14,218</u>	<u>\$3,130,149</u>	<u>\$ —</u>	<u>\$3,144,367</u>
	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
<b>September 30, 2017</b>				
Available-for-sale investment securities:				
Obligations of U. S. government sponsored enterprises and agencies	\$ —	\$ 73,588	\$ —	\$ 73,588
Obligations of states and political subdivisions	—	1,434,194	—	1,434,194
Corporate bonds	—	15,099	—	15,099
Residential mortgage-backed securities	—	1,029,284	—	1,029,284
Commercial mortgage-backed securities	—	328,862	—	328,862
Other securities	4,456	—	—	4,456
Total	<u>\$ 4,456</u>	<u>\$2,881,027</u>	<u>\$ —</u>	<u>\$2,885,483</u>

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<b>December 31, 2017</b>	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
<b>Available-for-sale investment securities:</b>				
Obligations of U. S. government sponsored enterprises and agencies	\$ —	\$ 60,330	\$ —	\$ 60,330
Obligations of states and political subdivisions	—	1,420,850	—	1,420,850
Corporate bonds	—	7,031	—	7,031
Residential mortgage-backed securities	—	1,219,097	—	1,219,097
Commercial mortgage-backed securities	—	375,737	—	375,737
Other securities	4,428	—	—	4,428
<b>Total</b>	<b><u>\$ 4,428</u></b>	<b><u>\$3,083,045</u></b>	<b><u>\$ —</u></b>	<b><u>\$3,087,473</u></b>

Certain financial assets and financial liabilities are measured at fair value on a non-recurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis include the following at September 30, 2018:

**Impaired Loans** – Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral less costs to sell. Collateral values are estimated using Level 2 inputs based on observable market data. At September 30, 2018, impaired loans with a carrying value of \$25,587,000 were reduced by specific valuation reserves totaling \$4,988,000 resulting in a net fair value of \$20,599,000. The Company also had impaired loans of \$7,732,000 with no specific valuation reserve at September 30, 2018, due to the loans carrying value generally being lower than the value of the collateral associated with the loan.

**Loans Held-for-Sale** – Loans held-for-sale are reported at either the fair value option or the lower of cost or fair value (see note 6).

**IRLC's and Forward Mortgage-Backed Securities Trades** – IRLCs and forward mortgage-backed securities trades are reported at fair value (see note 7).

Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include other real estate owned, goodwill and other intangible assets and other non-financial long-lived assets. Non-financial assets measured at fair value on a non-recurring basis during the three months and nine months ended September 30, 2018 and 2017 include other real estate owned which, subsequent to their initial transfer to other real estate owned from loans, were re-measured at fair value through a write-down included in gain (loss) on sale of foreclosed assets. During the reported periods, all fair value measurements for foreclosed assets utilized Level 2 inputs based on observable market data, generally third-party appraisals, or Level 3 inputs based on customized discounting criteria. These appraisals are evaluated individually and discounted as necessary due to the age of the appraisal, lack of comparable sales, expected holding periods of property or special use type of the property. Such discounts vary by appraisal based on the above factors but generally range from 5% to 25% of the appraised value. Re-evaluation of other real estate owned is performed at least annually as required by regulatory guidelines or more often if particular circumstances arise. The following table presents other real estate owned that were re-measured subsequent to their initial transfer to other real estate owned (dollars in thousands):

	Three Months Ended September 30,	
	2018	2017
Carrying value of other real estate owned prior to re-measurement	\$ —	\$ 937
Write-downs included in gain (loss) on sale of other real estate owned	—	(288)
<b>Fair value</b>	<b><u>\$ —</u></b>	<b><u>\$ 649</u></b>



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	Nine Months Ended	
	September 30,	
	2018	2017
Carrying value of other real estate owned prior to re-measurement	\$ 526	\$1,025
Write-downs included in gain (loss) on sale of other real estate owned	(126)	(296)
Fair value	<u>\$ 400</u>	<u>\$ 729</u>

At September 30, 2018 and 2017, and December 31, 2017, other real estate owned totaled \$593,000, \$2,176,000 and \$1,347,000, respectively.

The Company is required under current authoritative accounting guidance to disclose the estimated fair value of their financial instrument assets and liabilities including those subject to the requirements discussed above. For the Company, as for most financial institutions, substantially all of its assets and liabilities are considered financial instruments. Many of the Company's financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction.

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values. Cash and due from banks, federal funds sold, interest-bearing deposits and time deposits in banks and accrued interest receivable and payable are liquid in nature and considered Levels 1 or 2 of the fair value hierarchy.

Financial instruments with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities and are considered Levels 2 and 3 of the fair value hierarchy. Financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value and are considered Level 1 of the fair value hierarchy.

The carrying value and the estimated fair value of the Company's contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

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The estimated fair values and carrying values of all financial instruments under current authoritative guidance, were as follows (in thousands).

	September 30,				December 31,		Fair Value Hierarchy
	2018		2017		2017		
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value	
Cash and due from banks	\$ 164,998	\$ 164,998	\$ 177,615	\$ 177,615	\$ 209,583	\$ 209,583	Level 1
Interest-bearing deposits in banks	34,511	34,511	166,820	166,820	162,764	162,764	Level 1
Interest-bearing time deposits in banks	1,458	1,458	1,458	1,458	1,458	1,458	Level 2
Available-for-sale securities	3,144,367	3,144,367	2,885,483	2,885,483	3,087,473	3,087,473	Levels 1 and 2
Loans Held for Investment	3,816,169	3,857,059	3,424,305	3,439,484	3,437,413	3,455,003	Level 3
Loans Held for Sale	18,496	18,496	19,119	19,119	15,130	15,130	Level 3
Accrued interest receivable	28,990	28,990	26,321	26,321	36,081	36,081	Level 2
Deposits with stated maturities	450,667	450,409	464,782	465,655	451,255	452,000	Level 2
Deposits with no stated maturities	5,694,615	5,694,615	5,232,678	5,232,678	5,511,706	5,511,706	Level 1
Borrowings	380,760	380,760	351,435	351,435	331,000	331,000	Level 2
Accrued interest payable	303	303	179	179	197	197	Level 2

### **Note 13 - Recently Issued Authoritative Accounting Guidance**

*Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers.”* ASU 2014-09 implements a comprehensive new revenue recognition standard that supersedes substantially all existing revenue recognition guidance. The new standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity applies the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU 2015-4 “Revenue from Contracts with Customers – Deferral of the Effective Date” deferred the effective date of ASU 2014-09 by one year and as a result, the new standard became effective in the first quarter of 2018. The Company’s revenue is comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and non-interest income. Based on the Company’s analysis of the effect of the new standard on its recurring revenue streams, the Company did not expect these changes to have a significant impact on the Company’s financial statement, and upon adoption in the first quarter of 2018, no adjustment to opening retained earnings was recorded. See Note 1 for additional information related to the Company’s consideration and analysis of this new standard.

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*ASU 2016-1, “Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.”* ASU 2016-1, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-1 became effective for the Company on January 1, 2018 and did not have a significant impact on the Company’s financial statements.

*ASU 2016-02, “Leases.”* ASU 2016-02 will amend current lease accounting to require lessees to recognize (i) a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis, and (ii) a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, certain changes were made to align, where necessary, lessor accounting with the lessee accounting model. The amended guidance will be effective in the first quarter of 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company has evaluated the provision of the new lease standard and, due to the small dollar amounts and number of lease agreements, all considered operating leases, expected to be in effect for the Company at the effective date will not have a significant impact on the Company’s financial statements.

*ASU 2016-09, “Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting.”* ASU 2016-09 amends current guidance such that all excess tax benefits and tax deficiencies related to share-based payment awards will be recognized as income tax expense or benefit in the income statement during the period in which they occur. Previously, such amounts were recorded in capital surplus. Additionally, excess tax benefits will be classified along with other income tax cash flows as an operating activity rather than a financing activity, as was previously the case. ASU 2016-09 also provides that any entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest, which is the current requirement, or account for forfeitures when they occur. ASU 2016-09 became effective January 1, 2017 and did not have a significant impact on the Company’s financial statements.

*ASU 2016-13, “Financial Instruments – Credit Losses.”* ASU 2016-13 implements a comprehensive change in estimating the allowances for loan losses from the current model of losses inherent in the loan portfolio to a current expected credit loss model that generally is expected to result in earlier recognition of allowances for losses. Additionally, purchase accounting rules have been modified as well as credit losses on held-to-maturity debt securities. ASU 2016-13 will be effective in the first quarter of 2020. While the Company generally expects that the implementation of ASU 2016-13 will increase their allowance for loan losses balance, the Company is continuing to evaluate the potential impact on the Company’s financial statements.

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ASU 2017-04, “*Intangibles – Goodwill and Other.*” ASU 2017-04 will amend and simplify current goodwill impairment testing to eliminate Step 2 from the current provisions. Under the new guidance, an entity should perform the goodwill impairment test by comparing the fair value of a reporting unit with its carrying value and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value. An entity still has the option to perform the quantitative assessment for a reporting unit to determine if a quantitative impairment test is necessary. ASU 2017-04 will be effective for the Company on January 1, 2020 and is not expected to have a significant impact on the Company’s financial statements.

ASU 2017-07, “*Compensation – Retirement Benefits, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Post-Retirement Benefit Cost.*” ASU 2017-17 will require employers that sponsor defined benefit pension plans to present the service cost component of net periodic benefit cost in the same income statement line item as other employee compensation costs arising from services rendered during the period. Other components of the net periodic benefit cost will be presented separately from the service cost component. ASU 2017-17 became effective in 2018 and, as the Company froze its defined benefit pension plan in 2004, there is no service cost component of its net periodic benefit cost and therefore did not have an impact on the Company’s financial statements.

ASU 2017-08, “*Receivables – Nonrefundable Fees and Other Costs: Premium Amortization on Purchased Callable Debt Securities.*” ASU 2017-08 addresses the amortization method for all callable bonds purchased at a premium to par. Under the revised guidance, entities will be required to amortize premiums on callable bonds to the earliest call date. ASU 2017-08 is effective in 2019 although early adoption is permitted. The Company elected to early adopt ASU 2017-08 in the first quarter of 2017. The adoption of this guidance did not have a material impact on the Company’s financial statements.

ASU 2018-02, “*Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.*” ASU 2018-02 was issued to address the income tax accounting treatment of the stranded tax effects within other comprehensive income due to the prohibition of backward tracing due to an income tax rate change that was initially recorded in other comprehensive income. This issue came about from the enactment of the Tax Cuts and Jobs Act on December 22, 2017 that changed the Company’s income tax rate from 35% to 21%. The ASU changed current accounting whereby an entity may elect to reclassify the stranded tax effect from accumulated other comprehensive income to retained earnings. The ASU is effective for periods beginning after December 15, 2018 although early adoption was permitted. The Company early adopted ASU 2018-02 in the first quarter of 2018 and reclassified its stranded tax debit of \$5,759,000 within accumulated other comprehensive income to retained earnings.

ASU 2018-13, “*Fair Value Measurement (Topic 820).*” ASU 2018-13 eliminates, adds and modifies certain disclosure requirements for fair value measurements. ASU 2018-13 will be effective for the year ending December 31, 2020, including interim periods in that year.

ASU 2018-14, “*Compensation – Retirement Benefit Plans – General (Subtopic 715-20).*” ASU 2018-14 changes the disclosure requirement for employers that sponsor defined benefit pension and/or other post-retirement benefit plans, eliminating certain disclosures no longer considered cost beneficial and requiring new disclosures now considered more pertinent. ASU 2018-14 will be effective for the year ending December 31, 2020.

### **Note 14 – Acquisition**

On October 12, 2017, we entered into an agreement and plan of reorganization to acquire Commercial Bancshares, Inc. and its wholly owned bank subsidiary, Commercial State Bank, Kingwood, Texas. On January 1, 2018, the transaction was completed. Pursuant to the agreement, we issued 1,289,371 shares of the Company’s common stock in exchange for all of the outstanding shares of Commercial Bancshares, Inc. In addition, Commercial Bancshares, Inc. made a \$22,075,000 special dividend to its shareholders prior to closing of the transaction, which was increased for the amount by which Commercial Bancshares, Inc.’s consolidated shareholders’ equity as of January 1, 2018 exceeded \$42,402,000, after certain adjustments per the merger agreement.

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At closing, Commercial Bancshares, Inc. was merged into the Company and Commercial State Bank, Kingwood, Texas, was merged into First Financial Bank, National Association, Abilene, Texas, a wholly owned subsidiary of the Company. The primary purpose of the acquisition was to expand the Company's market share around Houston. Factors that contributed to a purchase price resulting in goodwill include Commercial State Bank's record of earnings, strong management and board of directors, strong local economic environment and opportunity for growth. The results of operations from this acquisition are included in the consolidated earnings of the Company commencing January 1, 2018.

The assets acquired and liabilities assumed were recorded on the consolidated balance sheet at estimated fair value on the acquisition date. The acquisition was not considered to be a significant business combination. The following table presents the amounts recorded on the consolidated balance sheet on the acquisition date (dollars in thousands):

Fair value of consideration paid:	
Common stock issued (1,289,371 shares)	<u>\$ 58,087</u>
Fair value of identifiable assets acquired:	
Cash and cash equivalents	18,653
Securities available-for-sale	64,501
Loans	266,327
Identifiable intangible assets	3,167
Other assets	<u>15,375</u>
Total identifiable assets acquired	<u>368,023</u>
Fair value of liabilities assumed:	
Deposits	341,902
Other liabilities	<u>(373)</u>
Total liabilities assumed	<u>341,529</u>
Fair value of net identifiable assets acquired	26,494
Goodwill resulting from acquisition	<u>\$ 31,593</u>

Goodwill recorded in the acquisition was accounted for in accordance with the authoritative business combination guidance. Accordingly, goodwill will not be amortized but will be tested for impairment annually. The goodwill recorded is not deductible for federal income tax purposes.

The fair value of total loans acquired was \$266,327,000 at acquisition compared to contractual amounts of \$271,714,000. The fair value of purchased credit impaired loans at acquisition was \$3,013,000 compared to contractual amounts of \$3,806,000. Additional purchased credit impaired loan disclosures were omitted due to immateriality. All other acquired loans were considered performing loans.

Commercial State Bank had branches in Kingwood, Fulshear, El Campo and Palacios, all located around Houston, Texas.

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

#### **Forward-Looking Statements**

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. When used in this Form 10-Q, words such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “predict,” “project,” and similar expressions, as they relate to us or our management, identify forward-looking statements. These forward-looking statements are based on information currently available to our management. Actual results could differ materially from those contemplated by the forward-looking statements as a result of certain factors, including, but not limited to, those listed in “Item 1A- Risk Factors” in our Annual Report on Form 10-K and the following:

- general economic conditions, including our local, state and national real estate markets and employment trends;
- effect of severe weather conditions, including hurricanes, tornadoes, flooding and droughts;
- volatility and disruption in national and international financial and commodity markets;
- government intervention in the U.S. financial system including the effects of recent legislative, tax, accounting and regulatory actions and reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the Jumpstart Our Business Startups Act, the Consumer Financial Protection Bureau, the capital ratios of Basel III as adopted by the federal banking authorities and the Tax Cuts and Jobs Act;
- political instability;
- the ability of the Federal government to address the national economy;
- changes in our competitive environment from other financial institutions and financial service providers;
- the effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”);
- the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply;
- changes in the demand for loans;
- fluctuations in the value of collateral securing our loan portfolio and in the level of the allowance for loan losses;
- the accuracy of our estimates of future loan losses;
- the accuracy of our estimates and assumptions regarding the performance of our securities portfolio;
- soundness of other financial institutions with which we have transactions;
- inflation, interest rate, market and monetary fluctuations;
- changes in consumer spending, borrowing and savings habits;
- changes in commodity prices (e.g., oil and gas, cattle and wind energy);
- our ability to attract deposits and increase market share;
- changes in our liquidity position;
- changes in the reliability of our vendors, internal control system or information systems;
- cyber attacks on our technology information systems, including fraud from our customers and external third party vendors;
- our ability to attract and retain qualified employees;
- acquisitions and integration of acquired businesses;
- the possible impairment of goodwill associated with our acquisitions;
- consequences of continued bank mergers and acquisitions in our market area, resulting in fewer but much larger and stronger competitors;

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- expansion of operations, including branch openings, new product offerings and expansion into new markets;
- changes in our compensation and benefit plans; and
- acts of God or of war or terrorism.

Such forward-looking statements reflect the current views of our management with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this paragraph. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise (except as required by law).

## Introduction

As a financial holding company, we generate most of our revenue from interest on loans and investments, trust fees, and service charges. Our primary source of funding for our loans and investments are deposits held by our subsidiary, First Financial Bank, National Association, Abilene, Texas. Our largest expense is salaries and related employee benefits. We usually measure our performance by calculating our return on average assets, return on average equity, our regulatory leverage and risk based capital ratios and our efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax equivalent basis and noninterest income.

The following discussion and analysis of operations and financial condition should be read in conjunction with the financial statements and accompanying footnotes included in Item 1 of this Form 10-Q as well as those included in the Company's 2017 Annual Report on Form 10-K.

## Critical Accounting Policies

We prepare consolidated financial statements based on GAAP and customary practices in the banking industry. These policies, in certain areas, require us to make significant estimates and assumptions.

We deem a policy critical if (1) the accounting estimate required us to make assumptions about matters that are highly uncertain at the time we make the accounting estimate; and (2) different estimates that reasonably could have been used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the financial statements.

We deem our most critical accounting policies to be (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities. We have other significant accounting policies and continue to evaluate the materiality of their impact on our consolidated financial statements, but we believe these other policies either do not generally require us to make estimates and judgments that are difficult or subjective, or it is less likely they would have a material impact on our reported results for a given period. A discussion of (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities is included in note 5 and note 4, respectively, to our notes to consolidated financial statements (unaudited) which begins on page 9.

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### **Developments**

#### **Hurricane Harvey**

Houston and the surrounding Gulf Coast region were significantly affected by Hurricane Harvey beginning in late August 2017 and continuing into the fourth quarter of 2017 and first quarter of 2018. Our Company has locations (i) north of Houston in Conroe, Willis, Tomball, Huntsville, Montgomery, Magnolia, New Waverly and Cut and Shoot and (ii) in Southeast Texas in Orange, Beaumont, Vidor, Newton, Mauriceville and Port Arthur. We continue to evaluate the effect of the hurricane on our branch facilities and our loan and investment portfolios. Our assessment of our physical buildings and equipment indicated damage primarily at our Mauriceville branch, and amounts not covered by insurance were not significant. At September 30, 2018, we had loans totaling \$474.32 million in our Conroe region and \$399.10 million in the Southeast Texas/Orange region. We continue to evaluate these loans and the related collateral and business operations underlying such loans, although through September 30, 2018, we have experienced minimal losses.

Our tax exempt municipal bonds in the counties of Texas effected by the hurricane have also been evaluated, including insurance on the bonds. At September 30, 2018, our municipal bonds in these counties totaled \$375.50 million, but only \$84.52 million do not have bond insurance. Based on analysis of these bonds and the related municipality, at September 30, 2018, we do not believe we have any credit related losses.

#### **Acquisition**

On October 12, 2017, we entered into an agreement and plan of reorganization to acquire Commercial Bancshares, Inc. and its wholly owned bank subsidiary, Commercial State Bank, Kingwood, Texas. On January 1, 2018, the transaction closed. Pursuant to the agreement, we issued 1,289,371 shares of the Company's common stock in exchange for all of the outstanding shares of Commercial Bancshares, Inc. In addition, in accordance with the plan of reorganization, Commercial Bancshares, Inc. paid a special dividend totaling \$22.08 million to its shareholders prior to the closing of this transaction. At the closing, Kingwood Merger Sub., Inc., a wholly-owned subsidiary of the Company, merged into Commercial Bancshares Inc., with Commercial Bancshares, Inc. surviving as a wholly-owned subsidiary of the Company. Immediately following such merger, Commercial Bancshares, Inc. was merged into the Company and Commercial State Bank, Kingwood, Texas was merged into First Financial Bank, National Association, Abilene, Texas, a wholly owned subsidiary of the Company. The total purchase price exceeded the estimated fair value net of assets acquired by approximately \$31.59 million and the Company recorded such excess as goodwill. The balance sheet and results of operations of Commercial Bancshares, Inc. have been included in the financial statements of the Company effective January 1, 2018. See note 14 to the consolidated financial statements on page 34 for additional information and disclosure.



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### **Results of Operations**

*Performance Summary.* Net earnings for the third quarter of 2018 were \$40.05 million, up \$10.68 million when compared with earnings of \$29.37 million in the same quarter last year. Basic earnings per share were \$0.59 for the third quarter of 2018 compared with \$0.44 in the same quarter a year ago. Contributing to the increase in net earnings and earnings per share in the current quarter when compared with the same quarter a year ago were the Kingwood acquisition and the recent enactment of tax legislation that reduced the corporate income tax rate from 35 percent to 21 percent. Without this tax adjustment, net earnings for the third quarter of 2018 would have been \$34.88 million with an adjusted basic earnings per share of \$0.52. See note 9 of the consolidated financial statements (unaudited) on page 26 for additional information.

The return on average assets was 2.10% for the third quarter of 2018, as compared to 1.65% for the third quarter of 2017. The return on average equity was 16.00% for the third quarter of 2018 as compared to 12.95% for the third quarter of 2017.

Net earnings for the nine-month period ended September 30, 2018 were \$112.20 million compared to \$84.23 million for the same period in 2017, or a 33.21% increase. Basic earnings per share for the first nine months of 2018 were \$1.66 compared to \$1.27 for the same period in 2017. Contributing to the increase in net earnings and basic earnings per share in the nine-month period when compared with the nine-month period a year ago were the Kingwood acquisition and the recent enactment of tax legislation that reduced the corporate income tax rate from 35 percent to 21 percent. Without this tax adjustment, net earnings for the first nine months of 2018 would have been \$98.13 million with an adjusted basic earnings per share of \$1.45. See note 9 of the consolidated financial statements (unaudited) on page 26 for additional information.

The return on average assets was 1.97% for the first nine months of 2018, as compared to 1.62% for the same period a year ago. The return on average equity was 15.43% for the first nine months of 2018, as compared to 12.88% a year ago.

*Net Interest Income.* Net interest income is the difference between interest income on earning assets and interest expense on liabilities incurred to fund those assets. Our earning assets consist primarily of loans and investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits.

Tax-equivalent net interest income was \$71.67 million for the third quarter of 2018, as compared to \$66.00 million for the same period last year. The increase in 2018 compared to 2017 was largely attributable to the increase in interest earning assets, primarily from the Kingwood acquisition. Average earning assets increased \$454.55 million for the third quarter of 2018 over the same period in 2017. Average loans and taxable securities increased \$377.31 million and \$450.88 million, respectively, for the third quarter of 2018 over the same quarter of 2017. Average tax-exempt securities decreased \$264.35 million for the third quarter of 2018 compared to the same period in 2017, primarily due to the Company's gradual shift away from tax-exempt securities due to the change in corporate tax rate to 21% from 35%. Average interest-bearing liabilities increased \$181.40 million for the third quarter of 2018, as compared to the same period in 2017. The yield on earning assets increased 15 basis points and the rate paid on interest-bearing liabilities increased 14 basis points for the third quarter of 2018 compared to the third quarter of 2017.

Tax-equivalent net interest income was \$209.48 million for the first nine months of 2018, as compared to \$195.16 million for the same period last year. The increase in 2018 compared to 2017 was largely attributable to the increase in volume of interest earning assets. Average earning assets increased \$599.49 million for the first nine months of 2018 over the same period in 2017, primarily from the Kingwood acquisition. Average loans and taxable securities increased \$378.50 million and \$474.54 million, respectively, for the first nine months of 2018 over the same period of 2017. Average tax-exempt securities decreased \$229.89 million for the first nine-month period in 2018 compared to the same period

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in 2017, primarily due to the Company's gradual shift away from tax-exempt securities due to the change in corporate tax rate to 21% from 35%. Average interest-bearing liabilities increased \$251.60 million for the first nine months of 2018, as compared to the same period in 2017. The yield on earning assets increased 4 basis points and the rate paid on interest-bearing liabilities increased 17 basis points for the first nine months of 2018 over the first nine months of 2017.

Table 1 allocates the change in tax-equivalent net interest income between the amount of change attributable to volume and to rate.

**Table 1 - Changes in Interest Income and Interest Expense (in thousands):**

	Three Months Ended September 30, 2018 Compared to Three Months Ended September 30, 2017			Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017		
	Change Attributable to		Total Change	Change Attributable to		Total Change
	Volume	Rate		Volume	Rate	
Short-term investments	\$ (347)	\$ 178	\$ (169)	\$ (191)	\$ 536	\$ 345
Taxable investment securities	2,441	2,079	4,520	7,795	5,023	12,818
Tax-exempt investment securities (1)	(3,021)	(2,404)	(5,425)	(7,886)	(7,954)	(15,840)
Loans (1) (2)	4,707	3,792	8,499	13,854	9,139	22,993
Interest income	3,780	3,645	7,425	13,572	6,744	20,316
Interest-bearing deposits	183	1,918	2,101	460	5,646	6,106
Short-term borrowings	(152)	(192)	(344)	(113)	4	(109)
Interest expense	31	1,726	1,757	347	5,650	5,997
Net interest income	\$ 3,749	\$ 1,919	\$ 5,668	\$ 13,225	\$ 1,094	\$ 14,319

(1) Computed on a tax-equivalent basis assuming a marginal tax rate of 21% for 2018 and 35% for 2017.

(2) Non-accrual loans are included in loans.

The net interest margin for the third quarter of 2018 was 4.01%, an increase of seven basis points from the same period in 2017. The net interest margin for the first nine months of 2018 was 3.94%, a decrease of seven basis points from the same period in 2017. The decrease in our net interest margin in 2018 from 2017 was primarily due to (i) the change in the income tax rate from 35% to 21% from the Tax Cuts and Jobs Act and its effect on our tax free municipal bonds and tax free loans and (ii) the result of the extended period of historically low levels of short-term interest rates, although rates have begun to increase in the past 18 months. We have been able to somewhat mitigate the impact of lower short-term interest rates by establishing minimum interest rates on certain of our loans, improving the pricing for loan risk, and minimizing rates paid on interest bearing liabilities. As rates have begun to increase, we are adjusting loan rates, upon maturities and converting to variable rates when we are able. We have also begun increasing rates paid on our interest-bearing deposits. The Federal Reserve increased rates 25 basis points in each of the first, second and third quarters of 2018 and 75 basis points in 2017, and continues to issue forward guidance plans to increase rates further in 2018 and 2019.

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The net interest margin, which measures tax-equivalent net interest income as a percentage of average earning assets, is illustrated in Table 2.

**Table 2 - Average Balances and Average Yields and Rates (in thousands, except percentages):**

	Three Months Ended September 30,					
	2018			2017		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
<b>Assets</b>						
Short-term investments (1)	\$ 91,495	\$ 469	2.03%	\$ 200,789	\$ 638	1.26%
Taxable investment securities (2)	1,943,125	12,594	2.59	1,492,246	8,074	2.16
Tax-exempt investment securities (2)(3)	1,213,212	11,459	3.78	1,477,559	16,884	4.57
Loans (3)(4)	3,845,836	51,769	5.34	3,468,524	43,270	4.95
Total earning assets	7,093,668	\$ 76,291	4.27%	6,639,118	\$ 68,866	4.12%
Cash and due from banks	171,498			157,983		
Bank premises and equipment, net	130,898			123,550		
Other assets	63,094			55,428		
Goodwill and other intangible assets, net	175,048			141,776		
Allowance for loan losses	(50,383)			(47,667)		
Total assets	<u>\$7,583,823</u>			<u>\$7,070,188</u>		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing deposits	\$4,035,174	\$ 4,329	0.43%	\$3,728,442	\$ 2,228	0.24%
Short-term borrowings	399,026	294	0.29	524,357	638	0.48
Total interest-bearing liabilities	4,434,200	4,623	0.41%	4,252,799	\$ 2,866	0.27%
Noninterest-bearing deposits	2,123,612			1,864,144		
Other liabilities	32,646			53,537		
Total liabilities	6,590,458			6,170,480		
Shareholders' equity	993,365			899,708		
Total liabilities and shareholders' equity	<u>\$7,583,823</u>			<u>\$7,070,188</u>		
Net interest income		<u>\$ 71,668</u>			<u>\$ 66,000</u>	
<b>Rate Analysis:</b>						
Interest income/earning assets			4.27%			4.12%
Interest expense/earning assets			0.26			0.18
Net interest margin			<u>4.01%</u>			<u>3.94%</u>

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	Nine Months Ended September 30,					
	2018			2017		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
<b>Assets</b>						
Short-term investments (1)	\$ 106,294	\$ 1,381	1.74%	\$ 129,945	\$ 1,036	1.07%
Taxable investment securities (2)	1,926,249	36,666	2.54	1,451,712	23,848	2.19
Tax-exempt investment securities (2)(3)	1,281,892	36,019	3.75	1,511,786	51,859	4.57
Loans (3)(4)	<u>3,797,602</u>	<u>148,140</u>	<u>5.22</u>	<u>3,419,105</u>	<u>125,147</u>	<u>4.89</u>
Total earning assets	7,112,037	\$222,206	4.18%	6,512,548	\$201,890	4.14%
Cash and due from banks	177,190			159,202		
Bank premises and equipment, net	128,863			123,110		
Other assets	61,941			57,191		
Goodwill and other intangible assets, net	171,623			142,885		
Allowance for loan losses	<u>(49,992)</u>			<u>(47,021)</u>		
Total assets	<u>\$7,601,662</u>			<u>\$6,947,915</u>		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing deposits	\$4,083,292	\$ 11,854	0.39%	\$3,779,967	\$ 5,748	0.20%
Short-term borrowings	<u>397,045</u>	<u>869</u>	<u>0.29</u>	<u>448,773</u>	<u>978</u>	<u>0.29</u>
Total interest-bearing liabilities	4,480,337	\$ 12,723	0.38%	4,228,740	\$ 6,726	0.21%
Noninterest-bearing deposits	2,119,208			1,797,174		
Other liabilities	<u>30,063</u>			<u>47,720</u>		
Total liabilities	6,629,608			6,073,634		
Shareholders' equity	<u>972,054</u>			<u>874,281</u>		
Total liabilities and shareholders' equity	<u>\$7,601,662</u>			<u>\$6,947,915</u>		
Net interest income		<u>\$209,483</u>			<u>\$195,164</u>	
<b>Rate Analysis:</b>						
Interest income/earning assets			4.18%			4.14%
Interest expense/earning assets			<u>0.24</u>			<u>0.13</u>
Net interest margin			<u>3.94%</u>			<u>4.01%</u>

- (1) Short-term investments are comprised of Fed Funds sold, interest-bearing deposits in banks and interest-bearing time deposits in banks.
- (2) Average balances include unrealized gains and losses on available-for-sale securities.
- (3) Computed on a tax-equivalent basis assuming a marginal tax rate of 21% for 2018 and 35% for 2017.
- (4) Non-accrual loans are included in loans.

*Noninterest Income.* Noninterest income for the third quarter of 2018 was \$27.06 million, an increase of \$2.80 million compared to the same period in 2017. Trust fees increased 20.71% to \$7.29 million in the third quarter of 2018 compared with \$6.04 million in the same quarter last year, due to continued growth in the fair value of trust assets managed to \$5.75 billion from \$4.92 billion a year ago and increases in revenue from oil and gas management. Service charges on deposit accounts increased 11.94% to \$5.69 million compared with \$5.08 million in the same quarter last year primarily due to continued growth in net new accounts, product and pricing changes made to better align the Company's account offerings and the Kingwood acquisition. ATM, interchange and credit card fees increased 18.82% to \$7.53 million compared with \$6.34 million in the same quarter last year due to continued growth in debit cards and the Kingwood acquisition. Real estate mortgage fees increased in the third quarter of 2018 to \$4.83 million compared with \$3.89 million in the same quarter a year ago due to increased value of loans originated and additional income from the change to mandatory delivery related to sales in the secondary mortgage market (see notes 6 and 7 to the consolidated financial statements (unaudited) on pages 24 and 25). Offsetting these increases were decreases in gains on the sale of securities of \$1.02 million compared to the same quarter in 2017.

Noninterest income for the nine-month period ended September 30, 2018 was \$76.97 million, an increase of \$8.25 million compared to the same period in 2017. Trust fees increased 19.44% to \$21.27 million in the first nine months of 2018 compared with \$17.80 million in the same period in 2017 due primarily to continued growth in the fair value of trust assets managed to \$5.75 billion from \$4.92 billion a year ago and increases in revenue from oil and gas management. Service charges on deposits increased 9.87% to

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\$15.95 million compared with \$14.52 million in the same period last year due primarily to the continued growth in net new accounts, product and pricing changes made to better align the Company's account offerings and the Kingwood acquisition. ATM, interchange and credit card fees increased 12.92% to \$21.57 million compared with \$19.10 million in the same period last year due to continued growth in debit cards and the Kingwood acquisition. Offsetting these increases were decreases in gain on sale of securities of \$479 thousand compared to the same period a year ago.

ATM and interchange fees are charges that merchants pay to us and other card-issuing banks for processing electronic payment transactions. ATM and interchange fees consist of income from debit card usage, point of sale income for debit card transactions and ATM service fees. Federal Reserve rules applicable to financial institutions that have assets of \$10 billion or more provide that the maximum permissible interchange fee for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. While we currently have assets under \$10 billion, we are monitoring the effect of this reduction in per transaction fee income as we approach the \$10 billion asset level.

**Table 3 - Noninterest Income (in thousands):**

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2018	Increase (Decrease)	2017	2018	Increase (Decrease)	2017
Trust fees	\$ 7,291	\$ 1,251	\$ 6,040	\$21,265	\$ 3,461	\$17,804
Service charges on deposit accounts	5,690	607	5,083	15,950	1,433	14,517
ATM, interchange and credit card fees	7,533	1,193	6,340	21,570	2,468	19,102
Real estate mortgage operations	4,834	943	3,891	11,718	222	11,496
Net gain on sale of available-for-sale securities	58	(1,017)	1,075	1,346	(479)	1,825
Net gain (loss) on sale of foreclosed assets	84	95	(11)	201	243	(42)
Net gain (loss) on sale of assets	(61)	(46)	(15)	(152)	59	(211)
Interest on loan recoveries	199	(206)	405	607	(289)	896
Other:						
Check printing fees	54	14	40	150	29	121
Safe deposit rental fees	112	4	108	436	12	424
Credit life fees	121	(35)	156	609	170	439
Brokerage commissions	422	99	323	1,286	378	908
Miscellaneous income	718	(107)	825	1,980	544	1,436
Total other	1,427	(25)	1,452	4,461	1,133	3,328
Total Noninterest Income	<u>\$27,055</u>	<u>\$ 2,795</u>	<u>\$24,260</u>	<u>\$76,966</u>	<u>\$ 8,251</u>	<u>\$68,715</u>

*Noninterest Expense.* Total noninterest expense for the third quarter of 2018 was \$47.51 million, an increase of \$3.54 million compared to \$43.96 million in the same period of 2017. An important measure in determining whether a financial institution effectively manages noninterest expense is the efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income. Lower ratios indicate better efficiency since more income is generated with a lower noninterest expense total. Our efficiency ratio for the third quarter of 2018 was 48.12%, compared to 48.71% for the same period in 2017.

Salaries and employee benefits for the third quarter of 2018 totaled \$26.38 million, an increase of \$2.23 million compared to the same period in 2017. The increase was primarily driven by (i) annual merit based pay increases that were effective March 1, 2018 (ii) an increase in our profit sharing expenses of \$593 thousand over the same quarter in 2017, and (iii) increases in all categories from the Kingwood acquisition. All other categories of noninterest expense for the third quarter of 2018 totaled \$21.13 million, up from \$19.82 million when compared to the same quarter in 2017, primarily from the Kingwood acquisition.

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Total noninterest expense for the first nine months of 2018 was \$142.45 million, an increase of \$12.56 million, compared to \$129.89 million in the same period of 2017. Our efficiency ratio for the first nine months of 2018 was 49.73%, compared to 49.22% from the same period in 2017.

Salaries and employee benefits for the first nine months of 2018 totaled \$79.44 million, an increase of \$8.58 million compared to the same period in 2017. The increase was primarily driven by (i) annual pay increases that were effective March 1, 2018, (ii) an increase in our profit sharing expense of \$2.14 million over the same period in 2017, and (iii) increases in all categories from the Kingwood acquisition including severance and stay pay amounts.

All other categories of noninterest expense for the first nine months of 2018 totaled \$63.01 million, an increase of approximately \$3.98 million, as compared to the same period in 2017, primarily from the Kingwood acquisition. Included in noninterest expense during the first nine months of 2018 were technology contract termination and conversion related costs totaling \$1.55 million related to the Kingwood acquisition.

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**Table 4 - Noninterest Expense (in thousands):**

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2018	Increase (Decrease)	2017	2018	Increase (Decrease)	2017
Salaries	\$20,074	\$ 1,908	\$18,166	\$ 59,633	\$ 5,611	\$ 54,022
Medical	2,082	(43)	2,125	6,594	393	6,201
Profit sharing	1,684	593	1,091	5,210	2,136	3,074
Pension	65	(19)	84	177	(76)	253
401(k) match expense	648	45	603	1,992	163	1,829
Payroll taxes	1,272	81	1,191	4,204	297	3,907
Stock option and stock grant expense	552	(331)	883	1,632	51	1,581
Total salaries and employee benefits	26,377	2,234	24,143	79,442	8,575	70,867
Net occupancy expense	2,900	189	2,711	8,589	508	8,081
Equipment expense	3,482	188	3,294	10,438	41	10,397
FDIC assessment fees	570	9	561	1,768	111	1,657
ATM, interchange and credit card expense	2,344	343	2,001	6,692	1,175	5,517
Professional and service fees	2,174	138	2,036	6,613	735	5,878
Printing, stationery and supplies	387	(62)	449	1,485	62	1,423
Operational and other losses	981	(100)	1,081	1,852	(787)	2,639
Software amortization and expense	540	(202)	742	1,542	(695)	2,237
Amortization of intangible assets	279	136	143	1,049	572	477
Other:						
Data processing fees	440	91	349	1,031	135	896
Postage	438	39	399	1,277	45	1,232
Advertising	943	49	894	2,682	33	2,649
Correspondent bank service charges	191	(24)	215	589	(73)	662
Telephone	878	141	737	2,716	413	2,303
Public relations and business development	766	133	633	2,178	181	1,997
Directors' fees	424	37	387	1,313	188	1,125
Audit and accounting fees	413	28	385	1,328	82	1,246
Legal fees	212	(119)	331	825	(604)	1,429
Regulatory exam fees	321	25	296	954	74	880
Travel	310	34	276	1,075	183	892
Courier expense	206	(31)	237	631	(26)	657
Other real estate	20	6	14	106	4	102
Other miscellaneous expense	1,910	260	1,650	6,273	1,625	4,648
Total other	7,472	669	6,803	22,978	2,260	20,718
Total Noninterest Expense	\$47,506	\$ 3,542	\$43,964	\$142,448	\$ 12,557	\$129,891

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### Balance Sheet Review

*Loans.* Our portfolio is comprised of loans made to businesses, professionals, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary bank. Real estate loans represent loans primarily for 1-4 family residences and commercial real estate. The structure of loans in the real estate mortgage area generally provides re-pricing intervals to minimize the interest rate risk inherent in long-term fixed rate loans. As of September 30, 2018, total loans held for investment were \$3.87 billion, an increase of \$381.47 million, as compared to December 31, 2017 balances. As compared to December 31, 2017, commercial loans increased \$89.83 million, agricultural loans decreased \$590 thousand, real estate loans increased \$311.93 million and consumer loans decreased \$19.70 million. Loans averaged \$3.85 billion during the third quarter of 2018, an increase of \$377.31 million from the prior year third quarter average balances. Loans averaged \$3.80 billion during the nine-month period ended September 30, 2018, an increase of \$378.50 million from the prior year nine-month average balances. The increased noted above were primarily due to the Kingwood acquisition.

**Table 5 - Composition of Loans (in thousands):**

	September 30,		December 31,
	2018	2017	2017
Commercial	\$ 773,924	\$ 674,947	\$ 684,099
Agricultural	93,953	83,005	94,543
Real estate	2,614,929	2,297,556	2,302,998
Consumer	384,234	416,719	403,929
Total loans held-for-investment	<u>\$3,867,040</u>	<u>\$3,472,227</u>	<u>\$ 3,485,569</u>

At September 30, 2018, our real estate loans represent approximately 67.62% of our loan portfolio and are comprised of (i) 1-4 family residence loans of 42.74%, (ii) commercial real estate loans of 29.10%, generally owner occupied, (iii) other loans, which includes ranches, hospitals and universities, of 14.08%, (iv) residential development and construction loans of 9.58%, which includes our custom and speculative home construction loans and (v) commercial development and construction loans of 4.50%.

Loans held for sale, consisting of secondary market mortgage loans, totaled \$18.50 million, \$19.12 million, and \$15.13 million at September 30, 2018 and 2017, and December 31, 2017, respectively. At September 30, 2018, \$2.54 million are valued using the lower of cost or fair value method and the remaining amount is valued under the fair value option method. Loans held for sale at December 31, 2017 and September 30, 2017 were valued at the lower of cost or fair value. See notes 6 and 7 to the consolidated financial statements (unaudited) related to the change to mandatory delivery for sales in the secondary mortgage market on pages 24 and 25.

*Asset Quality.* Our loan portfolio is subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectability of principal or interest under the original terms becomes doubtful. Nonaccrual, past due 90 days or more and still accruing, and restructured loans plus foreclosed assets were \$26.86 million at September 30, 2018, as compared to \$22.08 million at September 30, 2017 and \$20.12 million at December 31, 2017. As a percent of loans and foreclosed assets, these assets were 0.69% at September 30, 2018, as compared to 0.63% at September 30, 2017 and 0.57% at December 31, 2017. As a percent of total assets, these assets were 0.35% at September 30, 2018, as compared to 0.31% at September 30, 2017 and 0.28% at December 31, 2017. We believe the level of these assets to be manageable and are not aware of any material classified credits not properly disclosed as nonperforming at September 30, 2018.



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*Supplemental Oil and Gas Information.* As of September 30, 2018, the Company's exposure to the oil and gas industry totaled 2.88% of gross loans, or \$112.04 million, up 51.88 million from December 31, 2017 year-end levels, and consisted (based on collateral supporting the loan) of (i) development and production loans of 0.42%, (ii) oil and gas field servicing loans of 48.66%, (iii) real estate loans of 38.26%, (iv) accounts receivable and inventory of 2.87% and (v) other of 9.79%. The increase in oil and gas related loans at September 30, 2018 when compared to December 31, 2017 balances primarily resulted from the Kingwood acquisition and new loans and advances made in 2018. The Company instituted additional monitoring procedures for these loans and classified, downgraded and charged-off loans as appropriate. The following oil and gas information is as of and for the quarters ended September 30, 2018 and 2017, and December 31, 2017:

	<u>September 30,</u>		<u>December 31,</u>
	<u>2018</u>	<u>2017</u>	<u>2017</u>
Oil and gas related loans	\$112,039	\$69,433	\$ 60,164
Oil and gas related loans as a % of total loans	2.88%	1.99%	1.72%
Classified oil and gas related loans	\$ 4,861	\$21,817	\$ 20,346
Nonaccrual oil and gas related loans	\$ 1,825	\$ 1,569	\$ 1,414
Net charge-offs for oil and gas related loans for quarter/year then ended	\$ —	\$ —	\$ 50
Allowance for oil and gas related loans as a % of oil and gas loans	3.28%	6.03%	7.90%

**Table 6 – Non-accrual, Past Due 90 Days or More and Still Accruing, Restructured Loans and Foreclosed Assets (in thousands, except percentages):**

	<u>September 30,</u>		<u>December 31,</u>
	<u>2018</u>	<u>2017</u>	<u>2017</u>
Non-accrual loans*	\$25,587	\$18,750	\$ 17,670
Loans still accruing and past due 90 days or more	88	257	288
Troubled debt restructured loans**	513	668	627
Nonperforming Loans	26,188	19,675	18,585
Foreclosed assets	671	2,401	1,532
Total nonperforming assets	\$26,859	\$22,076	\$ 20,117
As a % of loans and foreclosed assets	0.69%	0.63%	0.57%
As a % of total assets	0.35%	0.31%	0.28%

\* Includes \$2.95 million, \$736 thousand and \$618 thousand of purchased credit impaired loans as of September 30, 2018 and 2017, and December 31, 2017, respectively.

\*\* Other troubled debt restructured loans of \$4.58 million, \$5.28 million and \$4.63 million, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans at September 30, 2018 and 2017, and December 31, 2017, respectively.

We record interest payments received on non-accrual loans as reductions of principal. Prior to the loans being placed on non-accrual, we recognized interest income on impaired loans of approximately \$263 thousand for the year ended December 31, 2017. If interest on these impaired loans had been recognized on a full accrual basis during the year ended December 31, 2017, such income would have approximated \$2.15 million. Such amounts for the 2018 and 2017 interim periods were not significant.

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*Provision and Allowance for Loan Losses.* The allowance for loan losses is the amount we determine as of a specific date to be appropriate to absorb probable losses on existing loans in which full collectability is unlikely based on our review and evaluation of the loan portfolio. For a discussion of our methodology, see note 5 to our notes to the consolidated financial statements (unaudited). The provision for loan losses was \$1.45 million for the third quarter of 2018, as compared to \$1.42 million for the third quarter of 2017. The provision for loan losses was \$3.87 million for the nine-month period ended September 30, 2018 as compared to \$5.09 million for the same period in 2017. The continued provision for loan losses in 2018 and 2017 reflects primarily the growth in the loan portfolio and the decrease in provision is due to continued improvement in overall credit metrics. As a percent of average loans, net loan charge-offs were 0.05% for the third quarter of 2018, as compared to 0.10% for the third quarter of 2017. As a percentage of average loans, net loan charge-offs were 0.04% for the first nine months of 2018, as compared to 0.12% for the first nine months of 2017. The allowance for loan losses as a percent of loans was 1.31% as of September 30, 2018, as compared to 1.37% as of September 30, 2017 and 1.38% as of December 31, 2017. Included in Table 7 is further analysis of our allowance for loan losses.

**Table 7 - Loan Loss Experience and Allowance for Loan Losses (in thousands, except percentages):**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Allowance for loan losses at period-end	\$ 50,871	\$ 47,922	\$ 50,871	\$ 47,922
Loans held for investment at period-end	\$3,867,040	\$3,472,227	\$3,867,040	\$3,472,227
Average loans for period	\$3,845,836	\$3,468,524	\$3,797,602	\$3,419,105
Net charge-offs/average loans (annualized)	0.05%	0.10%	0.04%	0.12%
Allowance for loan losses/period-end loans	1.31%	1.37%	1.31%	1.37%
Allowance for loan losses/non-accrual loans, past due 90 days still accruing and restructured loans	194.25%	243.57%	194.25%	243.57%

*Interest-Bearing Deposits in Banks.* At September 30, 2018, our interest-bearing deposits in banks were \$35.97 million compared to \$168.28 million at September 30, 2017 and \$164.22 million at December 31, 2017, respectively. At September 30, 2018, interest-bearing deposits in banks included \$1.46 million invested in FDIC-insured certificates of deposit, \$33.95 million maintained at the Federal Reserve Bank of Dallas and \$560 thousand on deposit with the Federal Home Loan Bank of Dallas (“FHLB”).

*Available-for-Sale and Held-to-Maturity Securities.* At September 30, 2018, securities with a fair value of \$3.14 billion were classified as securities available-for-sale. As compared to December 31, 2017, the available-for-sale portfolio at September 30, 2018 reflected (i) an increase in U.S. Treasury securities of \$9.93 million, (ii) a decrease of \$60.03 million in obligations of U.S. government sponsored enterprises and agencies, (iii) a decrease of \$228.96 million in obligations of states and political subdivisions, (iv) a decrease of \$6.72 million in corporate bonds and other, and (v) an increase of \$342.68 million in mortgage-backed securities. The shift to mortgage-backed securities from obligations of state and political subdivisions was due to the change in the federal income tax rate of 21% from 35% effective January 1, 2018. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

See note 4 to the consolidated financial statements (unaudited) for additional disclosures relating to the investment portfolio at September 30, 2018 and 2017, and December 31, 2017.

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**Table 8 - Maturities and Yields of Available-for-Sale Securities Held at September 30, 2018 (in thousands, except percentages):**

Available-for-Sale:	Maturing									
	One Year or Less		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
U.S. Treasury securities	\$ —	— %	\$ 9,929	2.52%	\$ —	— %	\$ —	— %	\$ 9,929	2.52%
Obligations of U.S. government sponsored enterprises and agencies	302	1.83	—	—	—	—	—	—	302	1.83
Obligations of states and political subdivisions	184,354	4.98	554,912	4.22	450,670	3.91	1,951	5.65	1,191,887	4.22
Corporate bonds and other securities	4,521	2.17	218	2.65	—	—	—	—	4,739	2.19
Mortgage-backed securities	12,505	1.73	1,251,704	2.46	673,301	3.05	—	—	1,937,510	2.66%
Total	\$201,682	4.71%	\$1,816,763	3.00%	\$1,123,971	3.40%	\$ 1,951	5.65%	\$3,144,367	3.25%

Amounts for held-to-maturity securities at September 30, 2018 are not included herein due to insignificance.

All yields are computed on a tax-equivalent basis assuming a marginal tax rate of 21%. Yields on available-for-sale securities are based on amortized cost. Maturities of mortgage-backed securities are based on contractual maturities and could differ due to prepayments of underlying mortgages. Maturities of other securities are reported at the earlier of maturity date or call date.

As of September 30, 2018, the investment portfolio had an overall tax equivalent yield of 3.25%, a weighted average life of 4.18 years and modified duration of 3.74 years.

*Deposits.* Deposits held by our subsidiary bank represent our primary source of funding. Total deposits were \$6.15 billion as of September 30, 2018, as compared to \$5.70 billion as of September 30, 2017 and \$5.96 billion as of December 31, 2017. The increase in deposits at September 30, 2018 was due primarily to the Kingwood acquisition. Table 9 provides a breakdown of average deposits and rates paid for the three and nine months periods ended September 30, 2018 and 2017.

**Table 9 — Composition of Average Deposits (in thousands, except percentages):**

	Three Months Ended September 30,			
	2018		2017	
	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	\$2,123,612	— %	\$1,864,144	— %
Interest-bearing deposits:				
Interest-bearing checking	1,987,884	0.54	1,878,400	0.31
Savings and money market accounts	1,582,698	0.29	1,378,258	0.14
Time deposits under \$100,000	197,713	0.24	208,848	0.17
Time deposits of \$100,000 or more	266,879	0.52	262,936	0.32
Total interest-bearing deposits	4,035,174	0.43%	3,728,442	0.24%
Total average deposits	\$6,158,786		\$5,592,586	

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	Nine Months Ended September 30,			
	2018		2017	
	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	\$2,119,208	— %	\$1,797,174	— %
Interest-bearing deposits:				
Interest-bearing checking	2,058,071	0.52	1,882,295	0.25
Savings and money market accounts	1,550,428	0.23	1,410,824	0.13
Time deposits under \$100,000	211,418	0.21	214,653	0.17
Time deposits of \$100,000 or more	263,375	0.43	272,195	0.32
Total interest-bearing deposits	<u>4,083,292</u>	<u>0.39</u>	<u>3,779,967</u>	<u>0.20</u>
Total average deposits	<u>\$6,202,500</u>		<u>\$5,577,141</u>	

*Borrowings.* Included in borrowings were federal funds purchased, securities sold under repurchase agreements and advances from the FHLB of \$380.76 million, \$351.44 million and \$331.00 million at September 30, 2018 and 2017 and December 31, 2017, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which we pledge certain securities that have a fair value equal to at least the amount of the borrowings. The average balance of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB were \$399.03 million and \$524.36 million in the third quarter of 2018 and 2017, respectively. The weighted average interest rates paid on these borrowings were 0.29% and 0.48% for the third quarters of 2018 and 2017, respectively. The average balances of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB was \$397.05 million and \$448.77 million for the nine-month periods ended September 30, 2018 and 2017, respectively. The weighted average interest rate paid on these short-term borrowings was 0.29% and 0.29% for the first nine months of 2018 and 2017, respectively.

### Capital Resources

We evaluate capital resources by our ability to maintain adequate regulatory capital ratios to do business in the banking industry. Issues related to capital resources arise primarily when we are growing at an accelerated rate but not retaining a significant amount of our profits or when we experience significant asset quality deterioration.

Total shareholders' equity was \$995.74 million, or 13.15% of total assets at September 30, 2018, as compared to \$906.56 million, or 12.93% of total assets at September 30, 2017 and \$922.77 million, or 12.72% of total assets at December 31, 2017. Included in shareholders' equity at September 30, 2018 and 2017 and December 31, 2017, were (\$25.10) million, \$38.95 million and \$35.43 million, respectively, in unrealized gains (losses) on investment securities available-for-sale, net of related income taxes. For the third quarter of 2018, total shareholders' equity averaged \$993.37 million, or 13.10% of average assets, as compared to \$899.71 million, or 12.73% of average assets, during the same period in 2017. For the nine months ended September 30, 2018, total shareholders' equity averaged \$972.06 million or 12.79%, as compared to \$874.28 million, or 12.58% of total assets during the same period in 2017.

Banking regulators measure capital adequacy by means of the risk-based capital ratios and the leverage ratio under the Basel III regulatory capital framework and prompt corrective action regulations. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories. Regulatory capital is then divided by risk-weighted assets to determine the risk-adjusted capital ratios. The leverage ratio is computed by dividing shareholders' equity less intangible assets by quarter-to-date average assets less intangible assets.

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Beginning in January 2016, under the Basel III regulatory capital framework, the implementation of the capital conservation buffer was effective for the Company starting at the 0.625% level and increasing 0.625% each year thereafter, until it reaches 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress and requires increased capital levels for the purpose of capital distributions and other payments. Failure to meet the amount of the buffer will result in restrictions on the Company's ability to make capital distributions, including dividend payments and stock repurchases, and to pay discretionary bonuses to executive officers.

As of September 30, 2018 and 2017, and December 31, 2017, we had a total capital to risk-weighted assets ratio of 20.34%, 19.54% and 19.85%, a Tier 1 capital to risk-weighted assets ratio of 19.19%, 18.35% and 18.66%; a common equity Tier 1 to risk-weighted assets ratio of 19.19%, 18.35% and 18.66% and a leverage ratio of 11.57%, 10.84% and 11.09%, respectively. The regulatory capital ratios as of September 30, 2018 and 2017, and December 31, 2017 were calculated under Basel III rules. There is no threshold for well-capitalized status for bank holding companies.

The regulatory capital ratios of the Company and Bank under the Basel III regulatory capital framework are as follows:

	<u>Actual</u>		<u>Minimum Capital Required Under Basel III Phase-In</u>		<u>Minimum Capital Required-Basel III Fully Phased-In</u>		<u>Required to be Considered Well-Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>As of September 30, 2018:</b>								
<i>Total Capital to Risk-Weighted Assets:</i>								
Consolidated	\$912,453	20.34%	\$ 442,997	9.875%	\$ 471,035	10.50%	—	N/A
First Financial Bank, N.A	\$819,222	18.31%	\$ 441,850	9.875%	\$ 469,815	10.50%	\$ 447,443	10.00%
<i>Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$860,848	19.19%	\$ 353,276	7.875%	\$ 381,314	8.50%	—	N/A
First Financial Bank, N.A	\$767,617	17.16%	\$ 352,362	7.875%	\$ 380,327	8.50%	\$ 357,955	8.00%
<i>Common Equity Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$860,848	19.19%	\$ 285,985	6.375%	\$ 314,023	7.00%	—	N/A
First Financial Bank, N.A	\$767,617	17.16%	\$ 285,245	6.375%	\$ 313,210	7.00%	\$ 290,838	6.50%
<i>Leverage Ratio:</i>								
Consolidated	\$860,848	11.57%	\$ 297,516	4.000%	\$ 297,516	4.00%	—	N/A
First Financial Bank, N.A	\$767,617	10.36%	\$ 296,444	4.000%	\$ 296,444	4.00%	\$ 370,554	5.00%

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	Actual		Minimum Capital Required Under Basel III Phase-In		Minimum Capital Required-Basel III Fully Phased-In		Required to be Considered Well - Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of September 30, 2017:</b>								
<i>Total Capital to Risk-Weighted Assets:</i>								
Consolidated	\$794,388	19.54%	\$ 376,053	9.25%	\$ 426,872	10.50%	—	N/A
First Financial Bank, N.A	\$693,155	17.10%	\$ 375,032	9.25%	\$ 425,712	10.50%	\$ 405,440	10.00%
<i>Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$745,856	18.35%	\$ 294,745	7.25%	\$ 345,563	8.50%	—	N/A
First Financial Bank, N.A	\$644,623	15.90%	\$ 293,944	7.25%	\$ 344,624	8.50%	\$ 324,352	8.00%
<i>Common Equity Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$745,856	18.35%	\$ 233,763	5.75%	\$ 284,581	7.00%	—	N/A
First Financial Bank, N.A	\$644,623	15.90%	\$ 233,128	5.75%	\$ 283,808	7.00%	\$ 263,536	6.50%
<i>Leverage Ratio:</i>								
Consolidated	\$745,856	10.84%	\$ 275,265	4.00%	\$ 275,265	4.00%	—	N/A
First Financial Bank, N.A	\$644,623	9.40%	\$ 274,314	4.00%	\$ 274,314	4.00%	\$ 342,893	5.00%
<b>As of December 31, 2017:</b>								
<i>Total Capital to Risk-Weighted Assets:</i>								
Consolidated	\$814,634	19.85%	\$ 379,578	9.250%	\$ 430,872	10.50%	—	N/A
First Financial Bank, N.A	\$723,563	17.68%	\$ 378,614	9.250%	\$ 429,777	10.50%	\$ 409,312	10.00%
<i>Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$765,882	18.66%	\$ 297,507	7.250%	\$ 348,801	8.50%	—	N/A
First Financial Bank, N.A	\$674,811	16.49%	\$ 296,751	7.250%	\$ 347,915	8.50%	\$ 327,450	8.00%
<i>Common Equity Tier 1 Capital to Risk-Weighted Assets:</i>								
Consolidated	\$765,882	18.66%	\$ 235,954	5.750%	\$ 287,248	7.00%	—	N/A
First Financial Bank, N.A	\$674,811	16.49%	\$ 235,354	5.750%	\$ 286,518	7.00%	\$ 266,053	6.50%
<i>Leverage Ratio:</i>								
Consolidated	\$765,882	11.09%	\$ 276,296	4.000%	\$ 276,296	4.00%	—	N/A
First Financial Bank, N.A	\$674,811	9.80%	\$ 275,320	4.000%	\$ 275,320	4.00%	\$ 344,151	5.00%

We have performed a preliminary assessment using the regulatory capital estimation tool made available by the OCC and believe the Company and Bank are prepared to meet the new requirements upon full adoption of Basel III that will be effective December 31, 2019.

In connection with the adoption of the Basel III regulatory capital framework, our subsidiary bank made the election to continue to exclude most accumulated other comprehensive income (“AOCI”) from capital in connection with its quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

### Interest Rate Risk

Interest rate risk results when the maturity or repricing intervals of interest-earning assets and interest-bearing liabilities are different. Our exposure to interest rate risk is managed primarily through our strategy of selecting the types and terms of interest-earning assets and interest-bearing liabilities that generate favorable earnings while limiting the potential negative effects of changes in market interest rates. We use no off-balance sheet financial instruments to manage interest rate risk.

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Our subsidiary bank has an asset liability management committee that monitors interest rate risk and compliance with investment policies. The subsidiary bank utilizes an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next twelve months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next twelve months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the re-pricing and maturity characteristics of the existing and projected balance sheet.

As of September 30, 2018, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 0.38% and 0.40%, respectively, relative to the current financial statement structure over the next twelve months, while a decrease in interest rates of 100 basis points would result in a negative variance in net interest income of 2.06% relative to the current financial statement structure over the next twelve months. We consider the likelihood of a decrease in interest rates beyond 100 basis points as of September 30, 2018 remote given the Federal Reserve's proposed rate increase. Our model simulation as of September 30, 2018 indicates that our balance sheet is more liability sensitive in the short-term categories. These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve-month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics on specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities re-price in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

Should we be unable to maintain a reasonable balance of maturities and repricing of our interest-earning assets and our interest-bearing liabilities, we could be required to dispose of our assets in an unfavorable manner or pay a higher than market rate to fund our activities. Our asset liability committee oversees and monitors this risk.

### **Liquidity**

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument. Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which include core depositors and correspondent banks that maintain accounts with and sell federal funds to our subsidiary bank. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB (see below) and an unfunded \$25.00 million revolving line of credit established with Frost Bank, a nonaffiliated bank, which matures in June 2019 (see next paragraph). Our subsidiary bank also has federal funds purchased lines of credit with two non-affiliated banks totaling \$130.00 million. At September 30, 2018, no amounts were drawn on these lines of credit. Our subsidiary bank also has available a line of credit with the FHLB totaling \$1.20 billion, at September 30, 2018, secured by portions of our loan portfolio and certain investment securities. At September 30, 2018, the Company had no advances or letters of credit outstanding under this line of credit.

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The Company renewed its loan agreement, effective June 30, 2017, with Frost Bank. Under the loan agreement, as renewed and amended, we are permitted to draw up to \$25.00 million on a revolving line of credit. Prior to June 30, 2019, interest is paid quarterly at *The Wall Street Journal* Prime Rate and the line of credit matures June 30, 2019. If a balance exists at June 30, 2019, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at our election at *The Wall Street Journal* Prime Rate plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured. Among other provisions in the credit agreement, we must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require us to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratios. In addition, the credit agreement contains certain operational covenants, which among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. The Company was in compliance with the financial and operational covenants at September 30, 2018. There was no outstanding balance under the line of credit as of September 30, 2018 or December 31, 2017.

In addition, we anticipate that future acquisitions of financial institutions, expansion of branch locations or offerings of new products could also place a demand on our cash resources. Available cash and cash equivalents at our parent company which totaled \$79.67 million at September 30, 2018, investment securities which totaled \$6.24 million at September 30, 2018 and mature over 10 to 12 years, available dividends from our subsidiaries which totaled \$228.95 million at September 30, 2018, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions.

Our liquidity position is continuously monitored and adjustments are made to the balance between sources and uses of funds as deemed appropriate. Liquidity risk management is an important element in our asset/liability management process. We regularly model liquidity stress scenarios to assess potential liquidity outflows or funding problems resulting from economic disruptions, volatility in the financial markets, unexpected credit events or other significant occurrences deemed potentially problematic by management. These scenarios are incorporated into our contingency funding plan, which provides the basis for the identification of our liquidity needs. As of September 30, 2018, management is not aware of any events that are reasonably likely to have a material adverse effect on our liquidity, capital resources or operations. Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary bank, we consider our current liquidity position to be adequate to meet our short-term and long-term liquidity needs. In addition, management is not aware of any regulatory recommendations regarding liquidity that would have a material adverse effect on us.

*Off-Balance Sheet Arrangements.* We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include unfunded lines of credit, commitments to extend credit and federal funds sold to correspondent banks and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in our consolidated balance sheets.

Our exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for unfunded lines of credit, commitments to extend credit and standby letters of credit is represented by the contractual notional amount of these instruments. We generally use the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments.

Unfunded lines of credit and 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. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the



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commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as we deem necessary upon extension of credit, is based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

Standby letters of credit are conditional commitments we issue to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The average collateral value held on letters of credit usually exceeds the contract amount.

**Table 10 – Commitments as of September 30, 2018 (in thousands):**

	<b>Total Notional Amounts Committed</b>
Unfunded lines of credit	\$ 663,381
Unfunded commitments to extend credit	286,217
Standby letters of credit	32,354
Total commercial commitments	<u>\$ 981,952</u>

We believe we have no other off-balance sheet arrangements or transactions with unconsolidated, special purpose entities that would expose us to liability that is not reflected on the face of the financial statements.

*Parent Company Funding.* Our ability to fund various operating expenses, dividends, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiaries. These funds historically have been produced by intercompany dividends and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiaries. At September 30, 2018, approximately \$228.95 million was available for the payment of intercompany dividends by our subsidiaries without the prior approval of regulatory agencies. Our subsidiaries paid aggregate dividends of \$38.95 million and \$29.00 million for the nine-month periods ended September 30, 2018 and 2017, respectively.

*Dividends.* Our long-term dividend policy is to pay cash dividends to our shareholders of approximately 40% of annual net earnings while maintaining adequate capital to support growth. We are also restricted by a loan covenant within our line of credit agreement with Frost Bank to dividend no greater than 55% of net income, as defined in such loan agreement. The cash dividend payout ratios have amounted to 36.79% and 43.99% of net earnings for the first nine months of 2018 and 2017, respectively. Given our current capital position and projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy.

Our bank subsidiary, which is a national banking association and a member of the Federal Reserve System, is required by federal law to obtain the prior approval of the OCC to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank's net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus.

To pay dividends, we and our subsidiary bank must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and

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hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve, the FDIC and the OCC have each indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Management considers interest rate risk to be a significant market risk for the Company. See "Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources - Interest Rate Risk" for disclosure regarding this market risk.

### **Item 4. Controls and Procedures**

As of September 30, 2018, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934). Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2018.

Subsequent to our evaluation, there were no significant changes in internal controls over financial reporting or other factors that have materially affected, or are reasonably likely to materially affect, these internal controls.

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**PART II  
OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time we and our subsidiaries are parties to lawsuits arising in the ordinary course of our banking business. However, there are no material pending legal proceedings to which we, our subsidiaries, or any of their properties, are currently subject. Other than regular, routine examinations by state and federal banking authorities, there are no proceedings pending or known to be contemplated by any governmental authorities.

**Item 1A. Risk Factors**

There has been no material change in the risk factors previously disclosed under Item 1A. of the Company's 2017 Annual Report on Form 10-K.

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

None

**Item 3. Defaults Upon Senior Securities**

Not Applicable

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

None

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### **Item 6. Exhibits**

2.1	—	<a href="#"><u>Agreement and Plan of Reorganization, dated October 12, 2017, by and among First Financial Bankshares, Inc., Kingwood Merger Sub, Inc., and Commercial Bancshares, Inc. (schedules have been omitted pursuant to Item 601(b)(2) of Regulation S-K) (incorporated by reference from Exhibit 2.1 to Registrant’s Form 8-K filed October 12, 2017).</u></a>
3.1	—	<a href="#"><u>Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant’s Form 8-K filed April 28, 2015).</u></a>
3.2	—	<a href="#"><u>Amended and Restated Bylaws of the Registrant (incorporated by reference from Exhibit 99.1 of the Registrant’s Form 8-K filed January 24, 2012).</u></a>
4.1	—	<a href="#"><u>Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant’s Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).</u></a>
10.1	—	<a href="#"><u>2002 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Registrant’s Form 10-Q filed May 4, 2010).++</u></a>
10.2	—	<a href="#"><u>2012 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant’s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 1, 2012).++</u></a>
10.3	—	<a href="#"><u>Loan agreement dated June 30, 2013, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant’s Form 8-K filed July 1, 2013).</u></a>
10.4	—	<a href="#"><u>First Amendment to Loan Agreement, dated June 30, 2015, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant’s Form 8-K filed June 30, 2015).</u></a>
10.5	—	<a href="#"><u>Second Amendment to Loan Agreement, dated June 30, 2017, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant’s Form 8-K filed June 30, 2017).</u></a>
10.6	—	<a href="#"><u>2015 Restricted Stock Plan (incorporated by reference from Appendix A of the Registrant’s Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 2, 2015).++</u></a>
10.7	—	<a href="#"><u>Form of Executive Recognition Agreement (incorporated by reference from Exhibit 10.1 of the Registrant’s Form 8-K filed June 29, 2018).++</u></a>
31.1	—	<a href="#"><u>Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.*</u></a>
31.2	—	<a href="#"><u>Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.*</u></a>
32.1	—	<a href="#"><u>Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.+</u></a>
32.2	—	<a href="#"><u>Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.+</u></a>
101.INS	—	XBRL Instance Document.*
101.SCH	—	XBRL Taxonomy Extension Schema Document.*
101.CAL	—	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	—	XBRL Taxonomy Extension Definition Linkbase Document.*
101.LAB	—	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	—	XBRL Taxonomy Extension Presentation Linkbase Document.*

\* Filed herewith

+ Furnished herewith. This Exhibit shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

++ Management contract or compensatory plan or arrangement.

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**SIGNATURES**

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

**FIRST FINANCIAL BANKSHARES, INC.**

**Date: October 30, 2018**

**By: /s/ F. Scott Dueser**  
**F. Scott Dueser**  
**President and Chief Executive Officer**

**Date: October 30, 2018**

**By: /s/ J. Bruce Hildebrand**  
**J. Bruce Hildebrand**  
**Executive Vice President and**  
**Chief Financial Officer**

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## **Section 2: EX-31.1 (EX-31.1)**

[Exhibit 31.1](#)

Certification of  
Chief Executive Officer  
of First Financial Bankshares, Inc.

I, F. Scott Dueser, President and Chief Executive Officer of First Financial Bankshares, Inc., certify that:

1. I have reviewed this Form 10-Q of First Financial Bankshares, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f), for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 30, 2018

By: /s/ F. SCOTT DUESER  
F. Scott Dueser  
President and Chief Executive Officer

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## Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

Certification of  
Chief Financial Officer  
of First Financial Bankshares, Inc.

I, J. Bruce Hildebrand, Executive Vice President and Chief Financial Officer of First Financial Bankshares, Inc., certify that:

1. I have reviewed this Form 10-Q of First Financial Bankshares, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f), for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 30, 2018

By: /s/ J. Bruce Hildebrand  
J. Bruce Hildebrand  
Executive Vice President and Chief Financial Officer

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## Section 4: EX-32.1 (EX-32.1)

Exhibit 32.1

Certification of  
Chief Executive Officer  
of First Financial Bankshares, Inc.

This certification is provided pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and accompanies the quarterly report on Form 10-Q (the "Form 10-Q") for the quarter ended September 30, 2018 of First Financial Bankshares, Inc. (the "Company").

I, F. Scott Dueser, the President and Chief Executive Officer of the Company, certify that:

1. the Form 10-Q fully complies with the requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and
2. the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: October 30, 2018

By: /s/ F. SCOTT DUESER  
F. Scott Dueser  
Chief Executive Officer

Subscribed and sworn to before me this 30th day of October, 2018.

/s/ Melissa Ann Fenton  
Melissa Ann Fenton  
Notary Public

My commission expires: October 11, 2020

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## Section 5: EX-32.2 (EX-32.2)

Exhibit 32.2

**Certification of  
Chief Financial Officer  
of First Financial Bankshares, Inc.**

This certification is provided pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and accompanies the quarterly report on Form 10-Q (the "Form 10-Q") for the quarter ended September 30, 2018 of First Financial Bankshares, Inc. (the "Company").

I, J. Bruce Hildebrand, the Executive Vice President and Chief Financial Officer of the Company, certify that:

1. the Form 10-Q fully complies with the requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and
2. the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: October 30, 2018

By: /s/ J. Bruce Hildebrand  
J. Bruce Hildebrand  
Chief Financial Officer

Subscribed and sworn to before me this 30th day of October, 2018.

/s/ Melissa Ann Fenton  
Melissa Ann Fenton  
Notary Public

My commission expires: October 11, 2020

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