

SOUTHSIDE BANCSHARES INC

Form 10-Q

July 28, 2017

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2017

OR

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

For the transition period from _____ to _____

Commission file number: 0-12247

SOUTHSIDE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

TEXAS

(State or other jurisdiction of incorporation or organization)

75-1848732

(I.R.S. Employer Identification No.)

1201 S. Beckham Avenue, Tyler, Texas

(Address of principal executive offices)

903-531-7111

(Registrant's telephone number, including area code)

75701

(Zip Code)

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 Regulation 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

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

Smaller reporting company

Emerging growth company

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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 Exchange Act).

Yes No

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of July 24, 2017 was 29,343,954 shares.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands, except share amounts)

| | June 30, 2017 | December 31, 2016 |
|--|------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$56,033 | \$ 59,363 |
| Interest earning deposits | 175,039 | 102,251 |
| Federal funds sold | 4,760 | 8,040 |
| Total cash and cash equivalents | 235,832 | 169,654 |
| Securities available for sale, at estimated fair value | 1,397,811 | 1,479,600 |
| Securities held to maturity, at carrying value (estimated fair value of \$943,776 and \$944,282, respectively) | 925,538 | 937,487 |
| FHLB stock, at cost | 61,561 | 61,084 |
| Other investments | 5,424 | 5,508 |
| Loans held for sale | 3,036 | 7,641 |
| Loans: | | |
| Loans | 2,610,198 | 2,556,537 |
| Less: Allowance for loan losses | (19,241) | (17,911) |
| Net Loans | 2,590,957 | 2,538,626 |
| Premises and equipment, net | 105,938 | 106,003 |
| Goodwill | 91,520 | 91,520 |
| Other intangible assets, net | 3,767 | 4,608 |
| Interest receivable | 23,220 | 25,183 |
| Deferred tax asset, net | 22,428 | 28,891 |
| Bank owned life insurance | 99,011 | 97,775 |
| Other assets | 12,439 | 10,187 |
| Total assets | \$5,578,482 | \$ 5,563,767 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Noninterest bearing | \$757,353 | \$ 704,013 |
| Interest bearing | 2,866,720 | 2,829,063 |
| Total deposits | 3,624,073 | 3,533,076 |
| Short-term obligations: | | |
| Federal funds purchased and repurchase agreements | 8,424 | 7,097 |
| FHLB advances | 1,015,833 | 866,518 |
| Total short-term obligations | 1,024,257 | 873,615 |
| Long-term obligations: | | |
| FHLB advances | 162,249 | 443,128 |
| Subordinated notes, net of unamortized debt issuance costs | 98,171 | 98,100 |
| Long-term debt, net of unamortized debt issuance costs | 60,238 | 60,236 |
| Total long-term obligations | 320,658 | 601,464 |
| Unsettled trades to purchase securities | 24,883 | 160 |
| Other liabilities | 37,546 | 37,178 |
| Total liabilities | 5,031,417 | 5,045,493 |

Off-balance-sheet arrangements, commitments and contingencies (Note 13)

Shareholders' equity:

| | | |
|--|-------------|-------------|
| Common stock (\$1.25 par value, 40,000,000 shares authorized, 32,245,251 shares issued at June 30, 2017 and 31,455,951 shares issued at December 31, 2016) | 40,306 | 39,320 |
| Paid-in capital | 561,728 | 535,240 |
| Retained earnings | 19,408 | 30,098 |
| Treasury stock, at cost (2,901,297 shares at June 30, 2017 and 2,913,064 shares at December 31, 2016) | (47,832) | (47,891) |
| Accumulated other comprehensive loss | (26,545) | (38,493) |
| Total shareholders' equity | 547,065 | 518,274 |
| Total liabilities and shareholders' equity | \$5,578,482 | \$5,563,767 |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

(in thousands, except per share data)

| | Three Months | | Six Months | |
|--|--------------|----------|------------|----------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Interest income | | | | |
| Loans | \$28,090 | \$26,233 | \$55,344 | \$53,998 |
| Investment securities – taxable | 267 | 107 | 644 | 321 |
| Investment securities – tax-exempt | 6,157 | 5,137 | 12,711 | 10,492 |
| Mortgage-backed securities | 10,818 | 9,366 | 20,863 | 18,757 |
| FHLB stock and other investments | 299 | 185 | 597 | 402 |
| Other interest earning assets | 378 | 61 | 738 | 131 |
| Total interest income | 46,009 | 41,089 | 90,897 | 84,101 |
| Interest expense | | | | |
| Deposits | 5,138 | 3,515 | 9,419 | 6,771 |
| Short-term obligations | 2,480 | 906 | 4,545 | 1,602 |
| Long-term obligations | 2,967 | 2,290 | 6,229 | 4,734 |
| Total interest expense | 10,585 | 6,711 | 20,193 | 13,107 |
| Net interest income | 35,424 | 34,378 | 70,704 | 70,994 |
| Provision for loan losses | 1,346 | 3,768 | 2,444 | 6,084 |
| Net interest income after provision for loan losses | 34,078 | 30,610 | 68,260 | 64,910 |
| Noninterest income | | | | |
| Deposit services | 5,255 | 5,099 | 10,369 | 10,184 |
| Net (loss) gain on sale of securities available for sale | (75) | 728 | 247 | 3,169 |
| Gain on sale of loans | 505 | 873 | 1,206 | 1,516 |
| Trust income | 899 | 869 | 1,789 | 1,724 |
| Bank owned life insurance income | 635 | 647 | 1,269 | 1,321 |
| Brokerage services | 682 | 535 | 1,229 | 1,110 |
| Other | 1,392 | 619 | 2,857 | 1,942 |
| Total noninterest income | 9,293 | 9,370 | 18,966 | 20,966 |
| Noninterest expense | | | | |
| Salaries and employee benefits | 14,915 | 14,849 | 30,834 | 32,581 |
| Occupancy expense | 2,897 | 2,993 | 5,760 | 6,328 |
| Advertising, travel & entertainment | 548 | 722 | 1,131 | 1,407 |
| ATM and debit card expense | 889 | 736 | 1,816 | 1,448 |
| Professional fees | 1,050 | 1,478 | 1,989 | 2,816 |
| Software and data processing expense | 688 | 739 | 1,413 | 1,488 |
| Telephone and communications | 476 | 468 | 1,002 | 952 |
| FDIC insurance | 445 | 645 | 886 | 1,283 |
| FHLB prepayment fees | — | 148 | — | 148 |
| Other | 3,629 | 3,035 | 6,564 | 6,769 |
| Total noninterest expense | 25,537 | 25,813 | 51,395 | 55,220 |
| Income before income tax expense | 17,834 | 14,167 | 35,831 | 30,656 |
| Income tax expense | 3,353 | 2,772 | 6,361 | 5,745 |

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| | | | | |
|-------------------------------------|----------|----------|----------|----------|
| Net income | \$14,481 | \$11,395 | \$29,470 | \$24,911 |
| Earnings per common share – basic | \$0.49 | \$0.42 | \$1.01 | \$0.92 |
| Earnings per common share – diluted | \$0.49 | \$0.42 | \$1.00 | \$0.92 |
| Dividends paid per common share | \$0.28 | \$0.24 | \$0.53 | \$0.47 |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(in thousands)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------|------------------|----------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Net income | \$14,481 | \$11,395 | \$29,470 | \$24,911 |
| Other comprehensive income: | | | | |
| Securities available for sale and transferred securities: | | | | |
| Change in net unrealized holding gains on available for sale securities during the period | 13,221 | 16,247 | 18,106 | 43,991 |
| Reclassification adjustment for amortization of unrealized losses on securities transferred to held to maturity | 213 | 87 | 701 | 144 |
| Reclassification adjustment for net loss (gain) on sale of available for sale securities, included in net income | 75 | (728) | (247) | (3,169) |
| Derivatives: | | | | |
| Change in net unrealized loss on effective cash flow hedge interest rate swap derivatives | (1,768) | (3,594) | (1,848) | (6,195) |
| Change in net unrealized gains on interest rate swap derivatives terminated during the period | — | — | 273 | — |
| Reclassification adjustment for net loss on interest rate swap derivatives, included in net income | 245 | 460 | 624 | 817 |
| Reclassification adjustment for amortization of unrealized gains on terminated interest rate swap derivatives | (22) | — | (31) | — |
| Pension plans: | | | | |
| Amortization of net actuarial loss, included in net periodic benefit cost | 416 | 502 | 807 | 913 |
| Amortization of prior service (credit) cost, included in net periodic benefit cost | (2) | 8 | (4) | 4 |
| Other comprehensive income, before tax | 12,378 | 12,982 | 18,381 | 36,505 |
| Income tax expense related to items of other comprehensive income | (4,332) | (4,544) | (6,433) | (12,777) |
| Other comprehensive income, net of tax | 8,046 | 8,438 | 11,948 | 23,728 |
| Comprehensive income | \$22,527 | \$19,833 | \$41,418 | \$48,639 |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
 (UNAUDITED)

(in thousands, except share and per share data)

| | Common Stock | Paid In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|-----------------|--------------------|----------------------|-------------------|--|----------------------------------|
| Balance at December 31, 2015 | \$ 34,832 | \$ 424,078 | \$ 41,527 | \$(37,692) | \$ (18,683) | \$ 444,062 |
| Net income | — | — | 24,911 | — | — | 24,911 |
| Other comprehensive income | — | — | — | — | 23,728 | 23,728 |
| Issuance of common stock for dividend reinvestment plan (23,015 shares) | 29 | 619 | — | — | — | 648 |
| Purchase of common stock (443,426 shares) | — | — | — | (10,199) | — | (10,199) |
| Stock compensation expense | — | 758 | — | — | — | 758 |
| Tax benefits related to stock awards | — | 17 | — | — | — | 17 |
| Net issuance of common stock under employee stock plans (23,168 shares) | 29 | 145 | (31) | — | — | 143 |
| Cash dividends paid on common stock (\$0.47 per share) | — | — | (11,768) | — | — | (11,768) |
| Stock dividend declared (1,252,353 shares) | 1,565 | 33,200 | (34,765) | — | — | — |
| Balance at June 30, 2016 | \$ 36,455 | \$ 458,817 | \$ 19,874 | \$(47,891) | \$ 5,045 | \$ 472,300 |
| Balance at December 31, 2016 | \$ 39,320 | \$ 535,240 | \$ 30,098 | \$(47,891) | \$ (38,493) | \$ 518,274 |
| Net income | — | — | 29,470 | — | — | 29,470 |
| Other comprehensive income | — | — | — | — | 11,948 | 11,948 |
| Issuance of common stock for dividend reinvestment plan (21,474 shares) | 27 | 694 | — | — | — | 721 |
| Stock compensation expense | — | 913 | — | — | — | 913 |
| Net issuance of common stock under employee stock plans (60,078 shares) | 60 | 820 | (49) | 59 | — | 890 |
| Cash dividends paid on common stock (\$0.53 per share) | — | — | (15,151) | — | — | (15,151) |
| Stock dividend declared (719,515 shares) | 899 | 24,061 | (24,960) | — | — | — |
| Balance at June 30, 2017 | \$ 40,306 | \$ 561,728 | \$ 19,408 | \$(47,832) | \$ (26,545) | \$ 547,065 |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
(UNAUDITED)
(in thousands)

| | Six Months Ended June 30, | |
|---|------------------------------|-----------|
| | 2017 | 2016 |
| OPERATING ACTIVITIES: | | |
| Net income | \$29,470 | \$24,911 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and net amortization | 4,846 | 4,328 |
| Securities premium amortization (discount accretion), net | 8,756 | 9,366 |
| Loan (discount accretion) premium amortization, net | (677) | (1,680) |
| Provision for loan losses | 2,444 | 6,084 |
| Stock compensation expense | 913 | 758 |
| Deferred tax expense | 17 | 506 |
| Net tax benefit related to stock awards | — | (17) |
| Net gain on sale of securities available for sale | (247) | (3,169) |
| Net loss (gain) on premises and equipment | 55 | (19) |
| Gross proceeds from sales of loans held for sale | 39,582 | 42,602 |
| Gross originations of loans held for sale | (34,977) | (44,674) |
| Net (gain) loss on other real estate owned | (1) | 147 |
| Net change in: | | |
| Interest receivable | 1,963 | 506 |
| Other assets | 2,479 | (2,599) |
| Interest payable | 60 | 378 |
| Other liabilities | (5,935) | (1,872) |
| Net cash provided by operating activities | 48,748 | 35,556 |
| INVESTING ACTIVITIES: | | |
| Securities available for sale: | | |
| Purchases | (272,410) | (355,720) |
| Sales | 328,854 | 352,299 |
| Maturities, calls and principal repayments | 62,242 | 97,816 |
| Securities held to maturity: | | |
| Purchases | (1,521) | (23,542) |
| Maturities, calls and principal repayments | 11,316 | 9,206 |
| Proceeds from redemption of FHLB stock and other investments | 114 | 3,644 |
| Purchases of FHLB stock and other investments | (477) | (235) |
| Net loans paydowns (originations) | (54,362) | 37,446 |
| Purchases of premises and equipment | (3,926) | (3,327) |
| Proceeds from sales of premises and equipment | 5 | 51 |
| Proceeds from sales of other real estate owned | 134 | 587 |
| Proceeds from sales of repossessed assets | 272 | 568 |
| Net cash provided by investing activities | 70,241 | 118,793 |

(continued)

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
(UNAUDITED) (continued)
(in thousands)

| | Six Months Ended June 30, | |
|---|------------------------------|-------------|
| | 2017 | 2016 |
| FINANCING ACTIVITIES: | | |
| Net change in deposits | \$90,953 | \$ 115,428 |
| Net increase in federal funds purchased and repurchase agreements | 1,327 | 8,636 |
| Proceeds from FHLB advances | 1,631,476 | 3,815,906 |
| Repayment of FHLB advances | (1,763,027) | (4,090,022) |
| Tax benefit related to stock awards | — | 17 |
| Proceeds from stock option exercises | 1,022 | 194 |
| Cash paid to tax authority from stock option exercises | (132) | (51) |
| Purchase of common stock | — | (10,199) |
| Proceeds from the issuance of common stock for dividend reinvestment plan | 721 | 648 |
| Cash dividends paid | (15,151) | (11,768) |
| Net cash used in financing activities | (52,811) | (171,211) |
| Net increase (decrease) in cash and cash equivalents | 66,178 | (16,862) |
| Cash and cash equivalents at beginning of period | 169,654 | 80,975 |
| Cash and cash equivalents at end of period | \$235,832 | \$64,113 |
| SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION: | | |
| Interest paid | \$20,134 | \$ 12,727 |
| Income taxes paid | \$5,500 | \$5,500 |
| SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES: | | |
| Loans transferred to other repossessed assets and real estate through foreclosure | \$263 | \$764 |
| Adjustment to pension liability | \$(803) | \$(917) |
| Stock dividend (2.5% and 5%, respectively) | \$24,960 | \$34,765 |
| Unsettled trades to purchase securities | \$(24,883) | \$(11,793) |

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting and Reporting Policies

Basis of Presentation

In this report, the words “the Company,” “we,” “us,” and “our” refer to the combined entities of Southside Bancshares, Inc. and its subsidiaries. The words “Southside” and “Southside Bancshares” refer to Southside Bancshares, Inc. The words “Southside Bank” and “the Bank” refer to Southside Bank. “Omni” refers to OmniAmerican Bancorp, Inc., a bank holding company acquired by Southside on December 17, 2014.

The consolidated balance sheet as of June 30, 2017, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, cash flows and notes to the financial statements for the three- and six-month periods ended June 30, 2017 and 2016 are unaudited; in the opinion of management, all adjustments necessary for a fair presentation of such financial statements have been included. Such adjustments consisted only of normal recurring items. All intercompany accounts and transactions are eliminated in consolidation. The preparation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires the use of management’s estimates. These estimates are subjective in nature and involve matters of judgment. Actual amounts could differ from these estimates.

On May 4, 2017, our board of directors declared a 2.5% stock dividend to common stock shareholders of record as of May 30, 2017, which was paid on June 27, 2017. All share data has been adjusted to give retroactive recognition to stock dividends.

Interim results are not necessarily indicative of results for a full year. These financial statements should be read in conjunction with the financial statements and notes thereto in our Annual Report on Form 10-K for the year ended December 31, 2016.

Accounting Changes and Reclassifications

Certain prior period amounts have been reclassified to conform to current year presentation.

We adopted ASU 2016-09 “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting,” on January 1, 2017 which requires all income tax effects related to settlements of share-based payment awards be reported in earnings as an increase (or decrease) to income tax expense. Previously, income tax benefits at settlement of an award were reported as an increase (or decrease) to additional paid-in capital to the extent that those benefits were greater than (or less than) the income tax benefits recognized in earnings during the vesting period or exercise of the award. The requirement to report those income tax effects in earnings has been applied to settlements occurring on or after January 1, 2017, and the impact of applying that guidance reduced reported income tax expense by \$84,000, or less than \$0.01 on our diluted earnings per common share for the three months ended June 30, 2017, and \$210,000, or \$0.01 on our diluted earnings per common share for the six months ended June 30, 2017. ASU 2016-09 also requires that all income tax-related cash flows resulting from share-based payments be reported as operating activities in the statement of cash flows. Previously, income tax benefits at settlement of an award were reported as a reduction to operating cash flows and an increase to financing cash flows to the extent that those benefits exceeded the income tax benefits reported in earnings during the vesting period or exercise of the award. We have elected to apply that change in cash flow on a prospective basis and therefore, prior periods have not been adjusted. ASU 2016-09 also requires the classification of employee taxes paid when an employer withholds shares for tax withholding purposes be classified as a financing activity in the statement of cash flow and be applied retrospectively. The requirement to report the employee taxes paid is reflected in prior period presentation in our consolidated statement of cash flows. In connection with the adoption of ASU 2016-09, we have also elected to recognize forfeitures as they occur.

Terminated Derivative Financial Instruments

In accordance with ASC Topic 815, if a hedging item is terminated prior to maturity for a cash settlement, the existing gain or loss within accumulated other comprehensive income (AOCI) will continue to be reclassified into earnings during the period or periods in which the hedged forecasted transaction affects earnings unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period. If the forecasted transaction is deemed probable to not occur, the derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately. During the first quarter of 2017, we terminated two interest rate swap contracts designated as cash flow hedges of forecasted transactions. At the time of termination, we determined that the underlying hedged forecasted transactions were still probable of occurring. These transactions are reevaluated on a monthly basis thereafter, to determine if the hedged forecasted transactions are still probable of occurring. If at a subsequent evaluation, it is determined that the transactions will not occur, any related gains or losses recorded in AOCI are immediately recognized in earnings.

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The existing gain in accumulated other comprehensive income related to the terminated interest rate swap contracts will be reclassified into earnings through straight-line accretion in the same periods the hedged forecasted transaction affects earnings.

Further information on our derivative instruments and hedging activities is included in “Note 10 - Derivative Financial Instruments and Hedging Activities.”

For a description of our significant accounting and reporting policies, refer to “Note 1- Summary of Significant Accounting and Reporting Policies” in our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016.

Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers (Topic 606).” This update states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update affects entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards. In August 2015, the FASB issued ASU 2015-14, “Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,” which defers the effective date of the previously issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) until the interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted. The guidance permits companies to either apply the requirements retrospectively to all prior periods presented, or apply the requirements in the year of adoption, through cumulative adjustment. We anticipate adopting the new standard using the modified retrospective method beginning January 1, 2018. Our revenue consists of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09, and noninterest income. We have evaluated the impact this guidance will have in relation to our noninterest income derived from contracts with our customers as it relates to deposit services, trust income, brokerage services, and merchant services (included in other noninterest income) which we have determined to be in the scope of ASU 2014-09. The adoption of ASU 2014-09 is not expected to have a material impact on our financials. We are continuing to evaluate the impact of the additional disclosures required by this guidance.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842).” ASU 2016-02 requires a lessee to recognize assets and liabilities for leases with lease terms of more than 12 months. Consistent with current GAAP, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. However, unlike current GAAP which requires only capital leases to be recognized on the balance sheet, the new ASU 2016-02 will require both finance (formerly known as “capital”) and operating leases to be recognized on the balance sheet. ASU 2016-02 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The guidance requires companies to apply the requirements in the year of adoption using a modified retrospective approach. We are currently evaluating the impact this guidance will have on our financial statements and we anticipate our assessment to be completed during the fiscal year 2018.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” ASU 2016-13 introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. ASU 2016-13 also modifies the impairment model for available for sale debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The guidance requires companies to apply the requirements in the year of adoption through cumulative adjustment with some aspects of the update requiring a prospective transition approach. We are currently evaluating the potential impact of the pending adoption of ASU 2016-13 on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” ASU 2017-04 is intended to simplify goodwill impairment testing by eliminating the

second step of the analysis which requires the calculation of the implied fair value of goodwill to measure a goodwill impairment charge. The update requires entities to compare the fair value of a reporting unit with its carrying amount and recognize an impairment charge for any amount by which the carrying amount exceeds the reporting unit's fair value, to the extent that the loss recognized does not exceed the amount of goodwill allocated to that reporting unit. ASU 2017-04 is effective for annual and interim goodwill impairment tests performed in periods beginning after December 15, 2019. Early adoption is permitted for annual and interim goodwill impairment testing dates after January 1, 2017. The guidance requires companies to apply the requirements prospectively in the year of adoption. ASU 2017-04 is not expected to have a significant impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-07, "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." ASU 2017-07 requires employers 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. Only the service cost component will be eligible for capitalization in assets. Employers are required to present the other components of the net periodic benefit cost separately from the line item that includes

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the service cost and outside of any subtotal of operating income, if one is presented. ASU 2017-07 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. We did not early adopt ASU 2017-04. The guidance requires companies to apply the requirements retrospectively to all prior periods presented. We are currently evaluating the potential impact of the pending adoption of ASU 2017-07 on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." Under current GAAP, premiums on callable debt securities are generally amortized over the contractual life of the security. ASU 2017-08 requires the premium on callable debt securities to be amortized to the earliest call date. If the debt security is not called at the earliest call date, the holder of the debt security would be required to reset the effective yield on the debt security based on the payment terms required by the debt security. ASU 2017-08 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The guidance requires companies to apply the requirements on a modified retrospective basis through a cumulative adjustment directly to retained earnings as of the beginning of the period of adoption. We are currently evaluating the potential impact of the pending adoption of ASU 2017-08 on our consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Subtopic 718): Scope of Modification Accounting." ASU 2017-09 clarifies when changes to terms or conditions of a share-based payment award must be accounted for as a modification. Under the new guidance, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: (i) the fair value of the award, (ii) the vesting conditions of the award, and (iii) the classification of the award as either an equity or liability instrument. ASU 2017-09 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The guidance requires companies to apply the requirements prospectively to awards modified on or after the adoption date. ASU 2017-09 is not expected to have a significant impact on our consolidated financial statements.

2. Pending Acquisition

On June 12, 2017, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Diboll State Bancshares, Inc., a Texas corporation ("Diboll") and the holding company for First Bank & Trust East Texas, a Texas banking association based in Diboll, Texas. As of June 30, 2017, Diboll had \$993.8 million in assets. The Merger Agreement provides that, subject to the terms and conditions thereof, Diboll will merge with and into the Company, with the Company as the surviving corporation. The merger is expected to close during the fourth quarter of 2017, after receipt of regulatory approvals, the approval of Diboll's shareholders, and the satisfaction of other customary closing conditions.

Pursuant to the Merger Agreement, the Company will issue 5,535,000 shares of Company common stock and up to \$25.0 million in cash for all outstanding shares of Diboll stock, subject to adjustment pursuant to the terms of the Merger Agreement.

3. Earnings Per Share

Earnings per share on a basic and diluted basis has been adjusted to give retroactive recognition to stock dividends and is calculated as follows (in thousands, except per share amounts):

| | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2016 | |
|-----------------------------|---|----------|---|----------|
| Basic and Diluted Earnings: | | | | |
| Net income | \$14,481 | \$11,395 | \$29,470 | \$24,911 |

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| | | | | |
|---|--------|--------|--------|--------|
| Basic weighted-average shares outstanding | 29,318 | 26,890 | 29,303 | 27,002 |
| Add: Stock awards | 201 | 123 | 208 | 97 |
| Diluted weighted-average shares outstanding | 29,519 | 27,013 | 29,511 | 27,099 |

Basic Earnings Per Share:

| | | | | |
|------------|--------|--------|--------|--------|
| Net Income | \$0.49 | \$0.42 | \$1.01 | \$0.92 |
|------------|--------|--------|--------|--------|

Diluted Earnings Per Share:

| | | | | |
|------------|--------|--------|--------|--------|
| Net Income | \$0.49 | \$0.42 | \$1.00 | \$0.92 |
|------------|--------|--------|--------|--------|

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For the three- and six-month periods ended June 30, 2017, there were approximately 52,000 and 51,000 anti-dilutive shares, respectively. For the three- and six-month periods ended June 30, 2016, there were approximately 23,000 and 54,000 anti-dilutive shares, respectively.

4. Accumulated Other Comprehensive Income (Loss)

The changes in accumulated other comprehensive income (loss) by component are as follows (in thousands):

| | Three Months Ended June 30, 2017 | | | | |
|--|---|--|---|-----------------|------------|
| | Unrealized Gains (Losses) on Securities | Unrealized Gains (Losses) on Derivatives | Pension Plans Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
| Beginning balance, net of tax | \$(20,425) | \$ 4,961 | \$(134) | \$(18,993) | \$(34,591) |
| Other comprehensive income (loss): | | | | | |
| Other comprehensive income (loss) before reclassifications | 13,221 | (1,768) | — | — | 11,453 |
| Reclassified from accumulated other comprehensive income (loss) | 288 | 223 | (2) | 416 | 925 |
| Income tax (expense) benefit | (4,728) | 541 | — | (145) | (4,332) |
| Net current-period other comprehensive income (loss), net of tax | 8,781 | (1,004) | (2) | 271 | 8,046 |
| Ending balance, net of tax | \$(11,644) | \$ 3,957 | \$(136) | \$(18,722) | \$(26,545) |
| | Six Months Ended June 30, 2017 | | | | |
| | Unrealized Gains (Losses) on Securities | Unrealized Gains (Losses) on Derivatives | Pension Plans Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
| Beginning balance, net of tax | \$(23,708) | \$ 4,595 | \$(133) | \$(19,247) | \$(38,493) |
| Other comprehensive income (loss): | | | | | |
| Other comprehensive income (loss) before reclassifications | 18,106 | (1,575) | — | — | 16,531 |
| Reclassified from accumulated other comprehensive income (loss) | 454 | 593 | (4) | 807 | 1,850 |
| Income tax (expense) benefit | (6,496) | 344 | 1 | (282) | (6,433) |
| Net current-period other comprehensive income (loss), net of tax | 12,064 | (638) | (3) | 525 | 11,948 |
| Ending balance, net of tax | \$(11,644) | \$ 3,957 | \$(136) | \$(18,722) | \$(26,545) |

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Three Months Ended June 30, 2016

| | Unrealized Gains (Losses) on Securities | Unrealized Gains (Losses) on Derivatives | Pension Plans Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
|--|---|---|--|--------------------|-------------|
| Beginning balance, net of tax | \$16,245 | \$ (1,459) | \$ (47) | \$ (18,132) | \$ (3,393) |
| Other comprehensive income (loss): | | | | | |
| Other comprehensive income (loss) before reclassifications | 16,247 | (3,594) | — | — | 12,653 |
| Reclassified from accumulated other comprehensive income (loss) | (641) | 460 | 8 | 502 | 329 |
| Income tax (expense) benefit | (5,462) | 1,097 | (3) | (176) | (4,544) |
| Net current-period other comprehensive income (loss), net of tax | 10,144 | (2,037) | 5 | 326 | 8,438 |
| Ending balance, net of tax | \$26,389 | \$ (3,496) | \$ (42) | \$ (17,806) | \$5,045 |

Six Months Ended June 30, 2016

| | Unrealized Gains (Losses) on Securities | Unrealized Gains (Losses) on Derivatives | Pension Plans Net Prior Service (Cost) Credit | Net Gain (Loss) | Total |
|--|---|---|--|--------------------|-------------|
| Beginning balance, net of tax | \$ (239) | \$ — | \$ (44) | \$ (18,400) | \$ (18,683) |
| Other comprehensive income (loss): | | | | | |
| Other comprehensive income (loss) before reclassifications | 43,991 | (6,195) | — | — | 37,796 |
| Reclassified from accumulated other comprehensive income (loss) | (3,025) | 817 | 4 | 913 | (1,291) |
| Income tax (expense) benefit | (14,338) | 1,882 | (2) | (319) | (12,777) |
| Net current-period other comprehensive income (loss), net of tax | 26,628 | (3,496) | 2 | 594 | 23,728 |
| Ending balance, net of tax | \$26,389 | \$ (3,496) | \$ (42) | \$ (17,806) | \$5,045 |

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The reclassifications out of accumulated other comprehensive income (loss) into net income are presented below (in thousands):

| | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2016 | |
|--|---|---------|---|----------|
| Unrealized losses on securities transferred to held to maturity: | | | | |
| Amortization of unrealized losses ⁽¹⁾ | \$(213) | \$(87) | \$(701) | \$(144) |
| Tax benefit | 75 | 30 | 245 | 50 |
| Net of tax | \$(138) | \$(57) | \$(456) | \$(94) |
| Unrealized gains and losses on available for sale securities: | | | | |
| Realized net (loss) gain on sale of securities ⁽²⁾ | \$(75) | \$728 | \$247 | \$3,169 |
| Tax benefit (expense) | 26 | (255) | (86) | (1,109) |
| Net of tax | \$(49) | \$473 | \$161 | \$2,060 |
| Derivatives: | | | | |
| Realized net loss on interest rate swap derivatives ⁽³⁾ | \$(245) | \$(460) | \$(624) | \$(817) |
| Tax benefit | 86 | 161 | 218 | 286 |
| Net of tax | \$(159) | \$(299) | \$(406) | \$(531) |
| Amortization of unrealized gains on terminated interest rate swap derivatives ⁽³⁾ | \$22 | \$— | \$31 | \$— |
| Tax expense | (8) | — | (11) | — |
| Net of tax | \$14 | \$— | \$20 | \$— |
| Amortization of pension plan: | | | | |
| Net actuarial loss ⁽⁴⁾ | \$(416) | \$(502) | \$(807) | \$(913) |
| Prior service credit (cost) ⁽⁴⁾ | 2 | (8) | 4 | (4) |
| Total before tax | (414) | (510) | (803) | (917) |
| Tax benefit | 145 | 179 | 281 | 321 |
| Net of tax | (269) | (331) | (522) | (596) |
| Total reclassifications for the period, net of tax | \$(601) | \$(214) | \$(1,203) | \$839 |

(1) Included in interest income on the consolidated statements of income.

(2) Listed as net (loss) gain on sale of securities available for sale on the consolidated statements of income.

(3) Included in interest expense for long-term obligations on the consolidated statements of income.

(4) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (income) presented in "Note 8 - Employee Benefit Plans."

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5. Securities

The amortized cost, gross unrealized gains and losses, carrying value, and estimated fair value of investment and mortgage-backed securities available for sale and held to maturity as of June 30, 2017 and December 31, 2016 are reflected in the tables below (in thousands):

| | June 30, 2017 | | | | Not recognized in OCI | | Estimated Fair Value |
|--|----------------|------------------------|-------------------------|----------------|------------------------|-------------------------|----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | |
| AVAILABLE FOR SALE | | | | | | | |
| Investment Securities: | | | | | | | |
| State and Political Subdivisions | \$ 330,155 | \$ 3,047 | \$ 7,043 | \$ 326,159 | \$ — | \$ — | \$ 326,159 |
| Other Stocks and Bonds | 5,059 | 85 | — | 5,144 | — | — | 5,144 |
| Other Equity Securities | 6,034 | — | 80 | 5,954 | — | — | 5,954 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 651,291 | 7,376 | 4,563 | 654,104 | — | — | 654,104 |
| Commercial | 405,217 | 2,467 | 1,234 | 406,450 | — | — | 406,450 |
| Total | \$ 1,397,756 | \$ 12,975 | \$ 12,920 | \$ 1,397,811 | \$ — | \$ — | \$ 1,397,811 |
| HELD TO MATURITY | | | | | | | |
| Investment Securities: | | | | | | | |
| State and Political Subdivisions | \$ 429,146 | \$ 3,196 | \$ 12,517 | \$ 419,825 | \$ 12,529 | \$ 2,199 | \$ 430,155 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 135,110 | — | 5,328 | 129,782 | 2,587 | 249 | 132,120 |
| Commercial | 379,250 | 983 | 4,302 | 375,931 | 6,364 | 794 | 381,501 |
| Total | \$ 943,506 | \$ 4,179 | \$ 22,147 | \$ 925,538 | \$ 21,480 | \$ 3,242 | \$ 943,776 |

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| | December 31, 2016 | | | | | | |
|--|-------------------|------------------------------|-------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
| | Amortized Cost | Recognized in OCI | | | Not recognized in OCI | | Estimated Fair Value |
| | | Gross Unrealized Gains | Gross Unrealized Losses | Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | |
| AVAILABLE FOR SALE | | | | | | | |
| Investment Securities: | | | | | | | |
| U.S. Treasury | \$74,016 | \$— | \$ 3,947 | \$70,069 | \$— | \$ — | \$70,069 |
| State and Political Subdivisions | 394,050 | 3,217 | 12,070 | 385,197 | — | — | 385,197 |
| Other Stocks and Bonds | 6,587 | 64 | — | 6,651 | — | — | 6,651 |
| Other Equity Securities | 6,039 | — | 119 | 5,920 | — | — | 5,920 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 630,603 | 6,434 | 9,529 | 627,508 | — | — | 627,508 |
| Commercial | 386,109 | 1,201 | 3,055 | 384,255 | — | — | 384,255 |
| Total | \$1,497,404 | \$10,916 | \$ 28,720 | \$1,479,600 | \$— | \$ — | \$1,479,600 |
| HELD TO MATURITY | | | | | | | |
| Investment Securities: | | | | | | | |
| State and Political Subdivisions | \$435,080 | \$3,987 | \$ 13,257 | \$425,810 | \$7,595 | \$ 3,493 | \$429,912 |
| Mortgage-backed Securities: ⁽¹⁾ | | | | | | | |
| Residential | 142,060 | — | 5,748 | 136,312 | 1,534 | 950 | 136,896 |
| Commercial | 379,016 | 1,067 | 4,718 | 375,365 | 4,372 | 2,263 | 377,474 |
| Total | \$956,156 | \$5,054 | \$ 23,723 | \$937,487 | \$13,501 | \$ 6,706 | \$944,282 |

(1) All mortgage-backed securities issued and/or guaranteed by U.S. government agencies or U.S. government-sponsored enterprises.

From time to time, we may transfer securities from available for sale (“AFS”) to held to maturity (“HTM”) due to overall balance sheet strategies. During 2016, the Company transferred securities with a fair value of \$157.1 million from AFS to HTM. The unrealized loss on the securities transferred from AFS to HTM was \$10.2 million (\$6.7 million, net of tax) at the date of transfer based on the fair value of the securities on the transfer date. Our management has the current intent and ability to hold the transferred securities until maturity. Any net unrealized gain or loss on the transferred securities included in accumulated other comprehensive income at the time of transfer will be amortized over the remaining life of the underlying security as an adjustment to the yield on those securities. AFS securities transferred with losses included in accumulated other comprehensive income continue to be included in management’s assessment for other-than-temporary impairment for each individual security. There were no securities transferred from AFS to HTM during the six months ended June 30, 2017.

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The following tables represent the estimated fair value and unrealized loss on securities AFS and HTM as of June 30, 2017 and December 31, 2016 (in thousands):

As of June 30, 2017

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|----------------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| AVAILABLE FOR SALE | | | | | | |
| Investment Securities: | | | | | | |
| State and Political Subdivisions | \$211,790 | \$ 6,653 | \$8,285 | \$ 390 | \$220,075 | \$ 7,043 |
| Other Equity Securities | 5,954 | 80 | — | — | 5,954 | 80 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 232,169 | 3,391 | 22,832 | 1,172 | 255,001 | 4,563 |
| Commercial | 98,096 | 1,234 | — | — | 98,096 | 1,234 |
| Total | \$548,009 | \$ 11,358 | \$31,117 | \$ 1,562 | \$579,126 | \$ 12,920 |

HELD TO MATURITY

| | | | | | | |
|----------------------------------|-----------|----------|----------|----------|-----------|----------|
| Investment Securities: | | | | | | |
| State and Political Subdivisions | \$59,673 | \$ 706 | \$32,490 | \$ 1,493 | \$92,163 | \$ 2,199 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 18,607 | 249 | — | — | 18,607 | 249 |
| Commercial | 49,291 | 794 | — | — | 49,291 | 794 |
| Total | \$127,571 | \$ 1,749 | \$32,490 | \$ 1,493 | \$160,061 | \$ 3,242 |

As of December 31, 2016

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|----------------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| AVAILABLE FOR SALE | | | | | | |
| Investment Securities: | | | | | | |
| U.S. Treasury | \$70,069 | \$ 3,947 | \$— | \$ — | \$70,069 | \$ 3,947 |
| State and Political Subdivisions | 264,485 | 12,069 | 887 | 1 | 265,372 | 12,070 |
| Other Equity Securities | 5,920 | 119 | — | — | 5,920 | 119 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 369,903 | 9,491 | 6,199 | 38 | 376,102 | 9,529 |
| Commercial | 245,422 | 3,055 | — | — | 245,422 | 3,055 |
| Total | \$955,799 | \$ 28,681 | \$7,086 | \$ 39 | \$962,885 | \$ 28,720 |

HELD TO MATURITY

| | | | | | | |
|----------------------------------|-----------|----------|----------|----------|-----------|----------|
| Investment Securities: | | | | | | |
| State and Political Subdivisions | \$179,939 | \$ 2,190 | \$29,427 | \$ 1,303 | \$209,366 | \$ 3,493 |
| Mortgage-backed Securities: | | | | | | |
| Residential | 107,024 | 950 | — | — | 107,024 | 950 |
| Commercial | 186,854 | 2,263 | — | — | 186,854 | 2,263 |
| Total | \$473,817 | \$ 5,403 | \$29,427 | \$ 1,303 | \$503,244 | \$ 6,706 |

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We review those securities in an unrealized loss position for significant differences between fair value and the cost basis to evaluate if a classification of other-than-temporary impairment is warranted. In estimating other-than-temporary impairment losses, management considers, among other things, the length of time and the extent to which the fair value has been less than cost and the financial condition and near-term prospects of the issuer. We consider an other-than-temporary impairment to have occurred when there is an adverse change in expected cash flows. When it is determined that a decline in fair value of HTM or AFS securities is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and a charge to other comprehensive income for the noncredit portion. Based upon the length of time and the extent to which fair value is less than cost, we believe that none of the securities with an unrealized loss have other-than-temporary impairment at June 30, 2017.

The majority of the securities in an unrealized loss position are highly rated municipal securities and U.S. Agency mortgage-backed securities (“MBS”) where the unrealized loss is a direct result of the change in interest rates and spreads. For those securities in an unrealized loss position, we do not currently intend to sell the securities and it is not more likely than not that we will be required to sell the securities before the anticipated recovery of their amortized cost basis. To the best of management’s knowledge and based on our consideration of the qualitative factors associated with each security, there were no securities in our investment and MBS portfolio with an other-than-temporary impairment at June 30, 2017.

Our equity securities consist of investments that are deemed to be qualified under the Community Reinvestment Act (CRA) of 1977. We primarily invest in securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae. We evaluate the near-term prospects of our other equity securities in relation to the severity and duration of the current unrealized loss position. Based upon that evaluation, management does not consider the other equity securities to be other-than-temporarily impaired at June 30, 2017.

The following tables present interest income recognized on securities for the periods presented (in thousands):

| | Three Months Ended June 30, 2017 | | 2016 |
|-------------------------------------|---|----------|------|
| U.S. Treasury | \$204 | \$21 | |
| State and Political Subdivisions | 6,157 | 5,137 | |
| Other Stocks and Bonds | 35 | 57 | |
| Other Equity Securities | 28 | 29 | |
| Mortgage-backed Securities | 10,818 | 9,366 | |
| Total interest income on securities | \$17,242 | \$14,610 | |
| | Six Months Ended June 30, 2017 | | 2016 |
| U.S. Treasury | \$519 | \$148 | |
| State and Political Subdivisions | 12,711 | 10,492 | |
| Other Stocks and Bonds | 69 | 115 | |
| Other Equity Securities | 56 | 58 | |
| Mortgage-backed Securities | 20,863 | 18,757 | |
| Total interest income on securities | \$34,218 | \$29,570 | |

Of the approximately \$247,000 in net securities gains from the AFS portfolio for the six months ended June 30, 2017, there were \$3.6 million in realized gain positions and \$3.3 million in realized loss positions. Of the \$3.2 million in net

securities gains from the AFS portfolio for the six months ended June 30, 2016, there were \$3.7 million in realized gain positions and \$551,000 in realized loss positions. There were no sales from the HTM portfolio during the six months ended June 30, 2017 or 2016. We calculate realized gains and losses on sales of securities under the specific identification method.

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The amortized cost, carrying value and estimated fair value of AFS and HTM securities at June 30, 2017, are presented below by contractual maturity (in thousands). Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. MBS are presented in total by category due to the fact that MBS typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with varying maturities. The characteristics of the underlying pool of mortgages, such as fixed-rate or adjustable-rate, as well as prepayment risk, are passed on to the security holder. The term of a mortgage-backed pass-through security thus approximates the term of the underlying mortgages and can vary significantly due to prepayments.

| | June 30, 2017 | |
|---|-------------------|-------------|
| | Amortized Cost | Fair Value |
| AVAILABLE FOR SALE | | |
| Investment Securities: | | |
| Due in one year or less | \$8,090 | \$8,220 |
| Due after one year through five years | 20,046 | 20,797 |
| Due after five years through ten years | 31,112 | 31,582 |
| Due after ten years | 275,966 | 270,704 |
| | 335,214 | 331,303 |
| Mortgage-backed Securities and Other Equity Securities: | 1,062,542 | 1,066,508 |
| Total | \$1,397,756 | \$1,397,811 |

| | June 30, 2017 | |
|--|-------------------|---------------|
| | Carrying Value | Fair Value |
| HELD TO MATURITY | | |
| Investment Securities: | | |
| Due in one year or less | \$22,130 | \$21,569 |
| Due after one year through five years | 41,941 | 42,155 |
| Due after five years through ten years | 106,435 | 108,483 |
| Due after ten years | 249,319 | 257,948 |
| | 419,825 | 430,155 |
| Mortgage-backed Securities: | 505,713 | 513,621 |
| Total | \$925,538 | \$943,776 |

Investment securities and MBS with carrying values of \$1.21 billion and \$1.50 billion were pledged as of June 30, 2017 and December 31, 2016, respectively, to collateralize Federal Home Loan Bank of Dallas ("FHLB") advances, repurchase agreements, and public funds or for other purposes as required by law.

Securities with limited marketability, such as FHLB stock and other investments, are carried at cost, which approximates fair value and are assessed quarterly for other-than-temporary impairment. These securities have no maturity date.

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6. Loans and Allowance for Probable Loan Losses

Loans in the accompanying consolidated balance sheets are classified as follows (in thousands):

| | June 30, 2017 | December 31, 2016 |
|--|------------------|----------------------|
| Real Estate Loans: | | |
| Construction | \$386,853 | \$ 380,175 |
| 1-4 Family Residential | 615,405 | 637,239 |
| Commercial | 1,033,629 | 945,978 |
| Commercial Loans | 172,311 | 177,265 |
| Municipal Loans | 305,023 | 298,583 |
| Loans to Individuals | 96,977 | 117,297 |
| Total Loans ⁽¹⁾ | 2,610,198 | 2,556,537 |
| Less: Allowance for Loan Losses ⁽²⁾ | 19,241 | 17,911 |
| Net Loans | \$2,590,957 | \$ 2,538,626 |

(1) Includes approximately \$295.6 million and \$372.4 million of loans acquired with the Omni acquisition as of June 30, 2017 and December 31, 2016, respectively.

(2) The allowance for loan loss recorded on purchase credit impaired ("PCI") loans totaled \$3,000 as of June 30, 2017 and December 31, 2016.

Real Estate Construction Loans

Our construction loans are collateralized by property located primarily in or near the market areas we serve. A number of our construction loans will be owner occupied upon completion. Construction loans for non-owner occupied projects are financed, but these typically have cash flows from leases with tenants, secondary sources of repayment, and in some cases, additional collateral. Our construction loans have both adjustable and fixed interest rates during the construction period. Construction loans to individuals are typically priced and made with the intention of granting the permanent loan on the property. Speculative and commercial construction loans are subject to underwriting standards similar to that of the commercial portfolio. Owner occupied 1-4 family residential construction loans are subject to the underwriting standards of the permanent loan.

Real Estate 1-4 Family Residential Loans

Residential loan originations are generated by our loan officers, in-house origination staff, marketing efforts, present customers, walk-in customers and referrals from real estate agents and builders. We focus our lending efforts primarily on the origination of loans secured by first mortgages on owner occupied 1-4 family residences. Substantially all of our 1-4 family residential originations are secured by properties located in or near our market areas.

Our 1-4 family residential loans generally have maturities ranging from five to 30 years. These loans are typically fully amortizing with monthly payments sufficient to repay the total amount of the loan. Our 1-4 family residential loans are made at both fixed and adjustable interest rates.

Underwriting for 1-4 family residential loans includes debt-to-income analysis, credit history analysis, appraised value and down payment considerations. Changes in the market value of real estate can affect the potential losses in the portfolio.

Commercial Real Estate Loans

Commercial real estate loans as of June 30, 2017 consisted of \$962.1 million of owner and non-owner occupied real estate, \$68.6 million of loans secured by multi-family properties and \$2.9 million of loans secured by farmland. Commercial real estate loans primarily include loans collateralized by retail, commercial office buildings, multi-family residential buildings, medical facilities and offices, senior living, assisted living and skilled nursing

facilities, warehouse facilities, hotels and churches. In determining whether to originate commercial real estate loans, we generally consider such factors as the financial condition of the borrower and the debt service coverage of the property. Commercial real estate loans are made at both fixed and adjustable interest rates for terms generally up to 20 years.

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Commercial Loans

Our commercial loans are diversified loan types including short-term working capital loans for inventory and accounts receivable and short- and medium-term loans for equipment or other business capital expansion. Management does not consider there to be a concentration of risk in any one industry type. In our commercial loan underwriting, we assess the creditworthiness, ability to repay, and the value and liquidity of the collateral being offered. Terms of commercial loans are generally commensurate with the useful life of the collateral offered.

Municipal Loans

We have a specific lending department that makes loans to municipalities and school districts primarily throughout the state of Texas. Municipal loans outside the state of Texas have been limited to adjoining states. The majority of the loans to municipalities and school districts have tax or revenue pledges and in some cases are additionally supported by collateral. Municipal loans made without a direct pledge of taxes or revenues are usually made based on some type of collateral that represents an essential service.

Loans to Individuals

Substantially all originations of our loans to individuals are made to consumers in our market areas. The majority of loans to individuals are collateralized by titled equipment, which are primarily automobiles. Loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The underwriting standards we employ for consumer loans include an application, a determination of the applicant's payment history on other debts, with the greatest weight being given to payment history with us, and an assessment of the borrower's ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, in relation to the proposed loan amount. Most of our loans to individuals are collateralized, which management believes should assist in limiting our exposure.

Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, we utilize historical net charge-off data to establish general reserve amounts for each class of loans. The historical charge-off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements not reflected in the historical data. Second, our lenders have the primary responsibility for identifying problem loans based on customer financial stress and underlying collateral. These recommendations are reviewed by senior loan administration, the special assets department, and the loan review department on a monthly basis. Third, the loan review department independently reviews the portfolio on an annual basis. The loan review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The loan review scope, as it relates to size, focuses more on larger dollar loan relationships, typically aggregate debt of \$500,000 or greater. The loan review officer also reviews specific reserves compared to general reserves to determine trends in comparative reserves as well as losses not reserved for prior to charge-off to determine the effectiveness of the specific reserve process.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If at the time of review we determine it is probable that we will not collect the principal and interest cash flows contractually due on the loan, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to determine the necessary allowances. The internal loan review department maintains a list ("Watch List") of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$150,000 or more is updated on a quarterly basis in order to properly determine necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

We calculate historical loss ratios for pools of loans with similar characteristics based on the proportion of actual charge-offs experienced, consistent with the characteristics of remaining loans, to the total population of loans in the pool. The historical gross loss ratios are updated quarterly based on actual charge-off experience and adjusted for qualitative factors. All loans are subject to individual analysis if determined to be impaired with the exception of consumer loans and loans secured by 1-4 family residential loans.

Industry and our own experience indicates that a portion of our loans will become delinquent and a portion of our loans will require partial or full charge-off. Regardless of the underwriting criteria utilized, losses may occur as a result of various factors beyond our control, including, among other things, changes in market conditions affecting the value of properties used as collateral for loans and problems affecting the credit worthiness of the borrower and the ability of the borrower to make payments on the

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loan. Our determination of the appropriateness of the allowance for loan losses is based on various considerations, including an analysis of the risk characteristics of various classifications of loans, previous loan loss experience, specific loans which have loan loss potential, delinquency trends, estimated fair value of the underlying collateral, current economic conditions, and geographic and industry loan concentration.

Credit Quality Indicators

We categorize loans into risk categories on an ongoing basis based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. We use the following definitions for risk ratings:

Pass (Rating 1 – 4) – This rating is assigned to all satisfactory loans. This category, by definition, consists of acceptable credit. Credit and collateral exceptions should not be present, although their presence would not necessarily prohibit a loan from being rated Pass, if deficiencies are in the process of correction. These loans are not included in the Watch List.

Pass Watch (Rating 5) – These loans require some degree of special treatment, but not due to credit quality. This category does not include loans specially mentioned or adversely classified; however, particular attention is warranted to characteristics such as:

- A lack of, or abnormally extended payment program;
- A heavy degree of concentration of collateral without sufficient margin;
- A vulnerability to competition through lesser or extensive financial leverage; and
- A dependence on a single or few customers or sources of supply and materials without suitable substitutes or alternatives.

Special Mention (Rating 6) – A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in our credit position at some future date. Special Mention loans are not adversely classified and do not expose us to sufficient risk to warrant adverse classification.

Substandard (Rating 7) – Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful (Rating 8) – Loans classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation, in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

All accruing loans are reserved for as a group of similar type credits and included in the general portion of the allowance for loan losses. Loans to individuals and 1-4 family residential loans, including loans not accruing, are collectively evaluated and included in the general portion of the allowance for loan losses. All loans considered troubled debt restructurings (“TDR”) are evaluated individually for impairment.

The general portion of the loan loss allowance is reflective of historical charge-off levels for similar loans adjusted for changes in current conditions and other relevant factors. These factors are likely to cause estimated losses to differ from historical loss experience and include:

- Changes in lending policies or procedures, including underwriting, collection, charge-off, and recovery procedures;
- Changes in local, regional and national economic and business conditions, including entry into new markets;
- Changes in the volume or type of credit extended;
- Changes in the experience, ability, and depth of lending management;
- Changes in the volume and severity of past due, nonaccrual, restructured, or classified loans;
- Changes in charge-off trends;
- Changes in loan review or Board oversight;
- Changes in the level of concentrations of credit; and

Changes in external factors, such as competition and legal and regulatory requirements.

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These factors are also considered for the purchased Omni loan portfolio specifically in regards to changes in credit quality, past due, nonaccrual and charge-off trends.

The following tables detail activity in the allowance for loan losses by portfolio segment for the periods presented (in thousands):

| | Three Months Ended June 30, 2017 | | | | | | |
|---|----------------------------------|------------------------|------------|------------------|-----------------|----------------------|----------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Balance at beginning of period | \$3,407 | \$ 2,317 | \$ 8,787 | \$ 2,259 | \$ 746 | \$ 969 | \$18,485 |
| Provision (reversal) for loan losses ⁽¹⁾ | 182 | 74 | 1,180 | (161) | 19 | 52 | 1,346 |
| Loans charged off | (17) | (1) | — | (574) | — | (496) | (1,088) |
| Recoveries of loans charged off | 1 | 2 | 3 | 100 | — | 392 | 498 |
| Balance at end of period | \$3,573 | \$ 2,392 | \$ 9,970 | \$ 1,624 | \$ 765 | \$ 917 | \$19,241 |

| | Six Months Ended June 30, 2017 | | | | | | |
|---|--------------------------------|------------------------|------------|------------------|-----------------|----------------------|----------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Balance at beginning of period | \$4,147 | \$ 2,665 | \$ 7,204 | \$ 2,263 | \$ 750 | \$ 882 | \$17,911 |
| Provision (reversal) for loan losses ⁽¹⁾ | (540) | 12 | 2,757 | (273) | 15 | 473 | 2,444 |
| Loans charged off | (35) | (288) | — | (577) | — | (1,242) | (2,142) |
| Recoveries of loans charged off | 1 | 3 | 9 | 211 | — | 804 | 1,028 |
| Balance at end of period | \$3,573 | \$ 2,392 | \$ 9,970 | \$ 1,624 | \$ 765 | \$ 917 | \$19,241 |

| | Three Months Ended June 30, 2016 | | | | | | |
|---|----------------------------------|------------------------|------------|---------------------------------|-----------------|----------------------|-----------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Commercial | Commercial Loans ⁽²⁾ | Municipal Loans | Loans to Individuals | Total |
| Balance at beginning of period | \$4,577 | \$ 2,155 | \$ 4,467 | \$ 8,964 | \$ 720 | \$ 916 | \$21,799 |
| Provision (reversal) for loan losses ⁽¹⁾ | (154) | (472) | 208 | 4,094 | (232) | 324 | 3,768 |
| Loans charged off | — | — | — | (10,650) | — | (654) | (11,304) |
| Recoveries of loans charged off | — | 3 | 5 | 66 | 249 | 322 | 645 |
| Balance at end of period | \$4,423 | \$ 1,686 | \$ 4,680 | \$ 2,474 | \$ 737 | \$ 908 | \$14,908 |

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Six Months Ended June 30, 2016

Real Estate

| | Construction | 1-4 Family Residential | Commercial | Commercial Loans ⁽²⁾ | Municipal Loans | Loans to Individuals | Total |
|---|--------------|------------------------|------------|---------------------------------|-----------------|----------------------|-----------|
| Balance at beginning of period | \$4,350 | \$ 2,595 | \$ 4,577 | \$ 6,596 | \$ 725 | \$ 893 | \$19,736 |
| Provision (reversal) for loan losses ⁽¹⁾ | (196) | (1,023) | 92 | 6,714 | (237) | 734 | 6,084 |
| Loans charged off | — | (19) | — | (10,923) | — | (1,502) | (12,444) |
| Recoveries of loans charged off | 269 | 133 | 11 | 87 | 249 | 783 | 1,532 |
| Balance at end of period | \$4,423 | \$ 1,686 | \$ 4,680 | \$ 2,474 | \$ 737 | \$ 908 | \$14,908 |

(1) Of the \$1.3 million and \$2.4 million recorded in provision for loan losses for the three and six months ended June 30, 2017, none related to provision expense on PCI loans. Of the \$3.8 million and \$6.1 million recorded in provision for loan losses for the three and six months ended June 30, 2016, approximately \$1.4 million related to provision expense on PCI loans as of June 30, 2016.

(2) Of the \$10.7 million and \$10.9 million in commercial charge-offs recorded for the three and six months ended June 30, 2016, \$10.6 million includes the partial charge-off of two large commercial borrowing relationships.

The following tables present the balance in the allowance for loan losses by portfolio segment based on impairment method (in thousands):

As of June 30, 2017

Real Estate

| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
|---|--------------|------------------------|------------|------------------|-----------------|----------------------|----------|
| Ending balance – individually evaluated for impairment ⁽¹⁾ | \$5 | \$ 13 | \$ 15 | \$ 154 | \$ 11 | \$ 96 | \$294 |
| Ending balance – collectively evaluated for impairment | 3,568 | 2,379 | 9,955 | 1,470 | 754 | 821 | 18,947 |
| Balance at end of period | \$3,573 | \$ 2,392 | \$ 9,970 | \$ 1,624 | \$ 765 | \$ 917 | \$19,241 |

As of December 31, 2016

Real Estate

| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
|---|--------------|------------------------|------------|------------------|-----------------|----------------------|----------|
| Ending balance – individually evaluated for impairment ⁽¹⁾ | \$13 | \$ 16 | \$ 17 | \$ 923 | \$ 11 | \$ 106 | \$1,086 |
| Ending balance – collectively evaluated for impairment | 4,134 | 2,649 | 7,187 | 1,340 | 739 | 776 | 16,825 |
| Balance at end of period | \$4,147 | \$ 2,665 | \$ 7,204 | \$ 2,263 | \$ 750 | \$ 882 | \$17,911 |

(1) There was approximately \$3,000 of allowance for loan losses associated with PCI loans as of June 30, 2017 and December 31, 2016.

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The following tables present the recorded investment in loans by portfolio segment based on impairment method (in thousands):

| | June 30, 2017 | | | | | | |
|---|-------------------|------------------------|--------------|------------------|-----------------|----------------------|-------------|
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Loans individually evaluated for impairment | \$53 | \$ 1,651 | \$ 1,033 | \$ 983 | \$ 571 | \$ 257 | \$4,548 |
| Loans collectively evaluated for impairment | 386,663 | 608,219 | 1,030,982 | 170,040 | 304,452 | 96,652 | 2,597,008 |
| Purchased credit impaired loans | 137 | 5,535 | 1,614 | 1,288 | — | 68 | 8,642 |
| Total ending loan balance | \$386,853 | \$ 615,405 | \$ 1,033,629 | \$ 172,311 | \$ 305,023 | \$ 96,977 | \$2,610,198 |
| | December 31, 2016 | | | | | | |
| | Real Estate | | | | | | |
| | Construction | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total |
| Loans individually evaluated for impairment | \$480 | \$ 1,693 | \$ 1,184 | \$ 5,840 | \$ 571 | \$ 241 | \$10,009 |
| Loans collectively evaluated for impairment | 379,526 | 629,893 | 942,818 | 170,159 | 298,012 | 116,923 | 2,537,331 |
| Purchased credit impaired loans | 169 | 5,653 | 1,976 | 1,266 | — | 133 | 9,197 |
| Total ending loan balance | \$380,175 | \$ 637,239 | \$ 945,978 | \$ 177,265 | \$ 298,583 | \$ 117,297 | \$2,556,537 |

The following tables set forth credit quality indicators by class of loans for the periods presented (in thousands):

| | June 30, 2017 | | | | | |
|------------------------|-------------------|----------------|---------------------|-----------------|--------------|-------------|
| | Pass | Pass Watch (1) | Special Mention (1) | Substandard (1) | Doubtful (1) | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$385,367 | \$33 | \$— | \$ 1,437 | \$ 16 | \$386,853 |
| 1-4 Family Residential | 611,148 | 13 | — | 3,899 | 345 | 615,405 |
| Commercial | 943,775 | 10,862 | 28,659 | 50,333 | — | 1,033,629 |
| Commercial Loans | 163,964 | 1,048 | 3,615 | 3,638 | 46 | 172,311 |
| Municipal Loans | 303,522 | — | 930 | 571 | — | 305,023 |
| Loans to Individuals | 96,021 | — | 31 | 545 | 380 | 96,977 |
| Total | \$2,503,797 | \$11,956 | \$33,235 | \$ 60,423 | \$ 787 | \$2,610,198 |
| | December 31, 2016 | | | | | |
| | Pass | Pass Watch (1) | Special Mention (1) | Substandard (1) | Doubtful (1) | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$374,443 | \$34 | \$571 | \$ 5,108 | \$ 19 | \$380,175 |
| 1-4 Family Residential | 632,937 | 68 | — | 3,380 | 854 | 637,239 |
| Commercial | 885,049 | 17,739 | 10,587 | 32,603 | — | 945,978 |
| Commercial Loans | 158,943 | 1,187 | 8,086 | 9,012 | 37 | 177,265 |
| Municipal Loans | 297,014 | — | 998 | 571 | — | 298,583 |
| Loans to Individuals | 115,952 | — | 9 | 629 | 707 | 117,297 |
| Total | \$2,464,338 | \$19,028 | \$20,251 | \$ 51,303 | \$ 1,617 | \$2,556,537 |

Includes PCI loans comprised of \$5,000 pass watch, \$499,000 special mention, \$1.0 million substandard and (1) \$28,000 doubtful as of June 30, 2017. Includes PCI loans comprised of \$5,000 pass watch, \$511,000 special mention, \$1.5 million substandard and \$28,000 doubtful as of December 31, 2016.

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Nonperforming Assets and Past Due Loans

Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. Additionally, some loans that are not delinquent or that are delinquent less than 90 days may be placed on nonaccrual status if it is probable that we will not receive contractual principal and interest payments in accordance with the terms of the respective loan agreement. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and any accrued balance is reversed for financial statement purposes. Payments received on nonaccrual loans are applied to the outstanding principal balance. Payments of contractual interest are recognized as income only to the extent that full recovery of the principal balance of the loan is reasonably certain. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower, are considered in judgments as to potential loan loss.

Nonaccrual loans and accruing loans past due more than 90 days include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

PCI loans are recorded at fair value at acquisition date. Although the PCI loans may be contractually delinquent, we do not classify these loans as past due or nonperforming as the loans were written down to fair value at the acquisition date and the accretable yield is recognized in interest income over the remaining life of the loan. However, subsequent to acquisition, we re-assess PCI loans for additional impairment and record additional impairment in the event we conclude it is probable that we will be unable to collect all cash flows originally expected to be collected at acquisition plus any additional cash flows expected to be collected due to changes in estimates after acquisition. All such PCI loans for which we recognize subsequent impairment are reported as impaired loans in the financial statements.

The following table sets forth nonperforming assets for the periods presented (in thousands):

| | At June 30, 2017 | At December 31, 2016 |
|--|---------------------------|-------------------------------|
| Nonaccrual loans ⁽¹⁾ | \$3,034 | \$ 8,280 |
| Accruing loans past due more than 90 days ⁽¹⁾ | — | 6 |
| Restructured loans ⁽²⁾ | 5,884 | 6,431 |
| Other real estate owned | 233 | 339 |
| Reposessed assets | 14 | 49 |
| Total Nonperforming Assets | \$9,165 | \$ 15,105 |

(1) Excludes PCI loans measured at fair value at acquisition.

(2) Includes \$3.0 million and \$3.1 million in PCI loans restructured as of June 30, 2017 and December 31, 2016, respectively.

Foreclosed assets include other real estate owned and reposessed assets. For 1-4 family residential real estate properties, a loan is recognized as a foreclosed property once legal title to the real estate property has been received upon completion of foreclosure or the borrower has conveyed all interest in the residential property through a deed in lieu of foreclosure. As of June 30, 2017, there were \$102,000 in loans secured by 1-4 family residential properties for which formal foreclosure proceedings were in process. As of December 31, 2016, there were \$28,000 in loans secured by 1-4 family residential properties for which formal foreclosure proceedings were in process.

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The following table sets forth the recorded investment in nonaccrual loans by class of loans for the periods presented (in thousands). The table excludes PCI loans measured at fair value at acquisition:

| | Nonaccrual Loans | |
|------------------------|------------------|-------------------|
| | June 30, 2017 | December 31, 2016 |
| Real Estate Loans: | | |
| Construction | \$53 | \$ 105 |
| 1-4 Family Residential | 1,012 | 1,067 |
| Commercial | 706 | 808 |
| Commercial Loans | 663 | 5,477 |
| Loans to Individuals | 600 | 823 |
| Total | \$3,034 | \$ 8,280 |

Loans are considered impaired if, based on current information and events, it is probable we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. The measurement of loss on impaired loans is generally based on the fair value of the collateral less selling costs if repayment is expected solely from the collateral or the present value of the expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement. In measuring the fair value of the collateral, in addition to relying on third party appraisals, we use assumptions, such as discount rates, and methodologies, such as comparison to the recent selling price of similar assets, consistent with those that would be utilized by unrelated third parties performing a valuation. Loans that are evaluated and determined not to meet the definition of an impaired loan are reserved for at the general reserve rate for its appropriate class.

At the time a loss is probable in the collection of contractual amounts, specific reserves are allocated. Loans are charged off to the liquidation value of the collateral net of liquidation costs, if any, when deemed uncollectible or as soon as collection by liquidation is evident.

The following tables set forth impaired loans by class of loans for the periods presented (in thousands). Impaired loans include restructured and nonaccrual loans for which the allowance was measured in accordance with section 310-10 of ASC Topic 310, "Receivables." There were no impaired loans recorded without an allowance as of June 30, 2017 or December 31, 2016.

| | June 30, 2017 | | Related Allowance for Loan Losses |
|------------------------|-----------------------------------|---------------------|-----------------------------------|
| | Unpaid Contract Principal Balance | Recorded Investment | |
| Real Estate Loans: | | | |
| Construction | \$60 | \$ 53 | \$ 5 |
| 1-4 Family Residential | 4,394 | 4,193 | 13 |
| Commercial | 1,486 | 1,406 | 15 |
| Commercial Loans | 1,204 | 1,100 | 154 |
| Municipal Loans | 571 | 571 | 11 |
| Loans to Individuals | 284 | 257 | 94 |
| Total ⁽¹⁾ | \$7,999 | \$ 7,580 | \$ 292 |

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| | December 31, 2016 | | |
|------------------------|---|------------------------|---|
| | Unpaid Contractual Principal Balance | Recorded Investment | Related Allowance for Loan Losses |
| Real Estate Loans: | | | |
| Construction | \$486 | \$ 480 | \$ 13 |
| 1-4 Family Residential | 4,487 | 4,264 | 16 |
| Commercial | 1,631 | 1,574 | 17 |
| Commercial Loans | 6,108 | 5,941 | 923 |
| Municipal Loans | 571 | 571 | 11 |
| Loans to Individuals | 277 | 241 | 106 |
| Total ⁽¹⁾ | \$13,560 | \$ 13,071 | \$ 1,086 |

(1) Includes \$3.0 million and \$3.1 million of PCI loans that experienced deterioration in credit quality subsequent to the acquisition date as of June 30, 2017 and December 31, 2016, respectively.

The following tables present the aging of the recorded investment in past due loans by class of loans (in thousands):

| | June 30, 2017 | | | | | |
|------------------------|------------------------------|------------------------------|---|----------------------|------------------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due | Current ⁽¹⁾ | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$— | \$ 17 | \$ 21 | \$ 38 | \$386,815 | \$386,853 |
| 1-4 Family Residential | 92 | 812 | 723 | 1,627 | 613,778 | 615,405 |
| Commercial | 168 | — | 81 | 249 | 1,033,380 | 1,033,629 |
| Commercial Loans | 263 | 80 | 48 | 391 | 171,920 | 172,311 |
| Municipal Loans | — | — | — | — | 305,023 | 305,023 |
| Loans to Individuals | 596 | 194 | 157 | 947 | 96,030 | 96,977 |
| Total | \$1,119 | \$1,103 | \$1,030 | \$3,252 | \$2,606,946 | \$2,610,198 |

| | December 31, 2016 | | | | | |
|------------------------|------------------------------|------------------------------|---|----------------------|------------------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due | Current ⁽¹⁾ | Total |
| Real Estate Loans: | | | | | | |
| Construction | \$917 | \$ 64 | \$ 86 | \$1,067 | \$379,108 | \$380,175 |
| 1-4 Family Residential | 6,225 | 755 | 600 | 7,580 | 629,659 | 637,239 |
| Commercial | 70 | 154 | 154 | 378 | 945,600 | 945,978 |
| Commercial Loans | 783 | 300 | 3,459 | 4,542 | 172,723 | 177,265 |
| Municipal Loans | 113 | — | — | 113 | 298,470 | 298,583 |
| Loans to Individuals | 1,550 | 320 | 185 | 2,055 | 115,242 | 117,297 |
| Total | \$9,658 | \$1,593 | \$4,484 | \$15,735 | \$2,540,802 | \$2,556,537 |

- (1) Includes PCI loans measured at fair value at acquisition.

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The following table sets forth average recorded investment and interest income recognized on impaired loans by class of loans for the periods presented (in thousands). The table excludes PCI loans measured at fair value at acquisition that have not experienced further deterioration in credit quality subsequent to the acquisition date:

| | Three Months Ended | | | |
|------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
| | June 30, 2017 | | June 30, 2016 | |
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Real Estate Loans: | | | | |
| Construction | \$344 | \$ — | \$584 | \$ 5 |
| 1-4 Family residential | 4,476 | 50 | 2,409 | 43 |
| Commercial | 1,158 | 10 | 5,403 | 21 |
| Commercial loans | 3,050 | 18 | 18,999 | 120 |
| Municipal loans | 571 | 8 | 637 | 9 |
| Loans to individuals | 226 | 1 | 263 | 2 |
| Total | \$9,825 | \$ 87 | \$28,295 | \$ 200 |
| | Six Months Ended | | | |
| | June 30, 2017 | | June 30, 2016 | |
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Real Estate Loans: | | | | |
| Construction | \$402 | \$ — | \$495 | \$ 12 |
| 1-4 Family Residential | 4,390 | 107 | 2,195 | 83 |
| Commercial | 1,322 | 25 | 5,294 | 43 |
| Commercial Loans | 4,244 | 36 | 20,158 | 292 |
| Municipal Loans | 571 | 15 | 637 | 17 |
| Loans to Individuals | 248 | 3 | 258 | 4 |
| Total | \$11,177 | \$ 186 | \$29,037 | \$ 451 |

Troubled Debt Restructurings

The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, restructuring amortization schedules and other actions intended to minimize potential losses. We may provide a combination of concessions which may include an extension of the amortization period, interest rate reduction, and/or converting the loan to interest-only for a limited period of time.

The following tables set forth the recorded balance of loans considered to be TDRs that were restructured and the type of concession during the periods presented (dollars in thousands):

| | Three Months Ended June 30, 2017 | | | | Number of Loans |
|----------------------|----------------------------------|--------------------------------|-------------|------------------------|-----------------------|
| | Extend Amortization Period | Interest Rate Reductions | Combination | Total Modifications | |
| Commercial Loans | \$797 | \$ — | \$ — | \$ 797 | 2 |
| Loans to Individuals | 23 | — | 40 | 63 | 3 |

Total \$820 \$ —\$ 40 \$ 860 5

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| | Six Months Ended June 30, 2017 | | | | | |
|------------------------|----------------------------------|------------|-------------|---------------|--|--------|
| | Extend | Interest | | Total | | Number |
| | Amortization | Rate | Combination | Modifications | | of |
| | Period | Reductions | | | | Loans |
| Commercial Loans | \$841 | \$ — | \$ — | \$ 841 | | 3 |
| Loans to Individuals | 29 | — | 51 | 80 | | 5 |
| Total | \$870 | \$ — | \$ 51 | \$ 921 | | 8 |
| | Three Months Ended June 30, 2016 | | | | | |
| | Extend | Interest | | Total | | Number |
| | Amortization | Rate | Combination | Modifications | | of |
| | Period | Reductions | | | | Loans |
| Real Estate Loans: | | | | | | |
| Construction | \$— | \$ — | \$ 24 | \$ 24 | | 1 |
| 1-4 Family Residential | — | 77 | 2,743 | 2,820 | | 2 |
| Loans to Individuals | 20 | — | 75 | 95 | | 6 |
| Total | \$20 | \$ 77 | \$ 2,842 | \$ 2,939 | | 9 |
| | Six Months Ended June 30, 2016 | | | | | |
| | Extend | Interest | | Total | | Number |
| | Amortization | Rate | Combination | Modifications | | of |
| | Period | Reductions | | | | Loans |
| Real Estate Loans: | | | | | | |
| Construction | \$463 | \$ — | \$ 24 | \$ 487 | | 2 |
| 1-4 Family Residential | — | 77 | 2,743 | 2,820 | | 2 |
| Other | 2,088 | — | — | 2,088 | | 1 |
| Commercial Loans | 1,154 | — | — | 1,154 | | 4 |
| Loans to Individuals | 20 | — | 75 | 95 | | 6 |
| Total | \$3,725 | \$ 77 | \$ 2,842 | \$ 6,644 | | 15 |

The majority of loans restructured as TDRs during the six months ended June 30, 2017 and 2016 were modified with maturity extensions. Interest continues to be charged on principal balances outstanding during the extended term. Therefore, the financial effects of the recorded investment of loans restructured as TDRs during the six months ended June 30, 2017 and 2016 were not significant. Generally, the loans identified as TDRs were previously reported as impaired loans prior to restructuring and therefore the modification did not impact our determination of the allowance for loan losses.

On an ongoing basis, the performance of the TDRs is monitored for subsequent payment default. Payment default for TDRs is recognized when the borrower is 90 days or more past due. For the three and six months ended June 30, 2017 and 2016, the amount of TDRs in default was not significant. Payment defaults for TDRs did not significantly impact the determination of the allowance for loan loss in either period presented.

At June 30, 2017 and 2016, there were no commitments to lend additional funds to borrowers whose terms had been modified in TDRs.

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Purchased Credit Impaired Loans

The following table presents the outstanding principal balance and carrying value for PCI loans for the periods presented (in thousands):

| | June 30, December 31, | |
|-------------------------------|-----------------------|-----------|
| | 2017 | 2016 |
| Outstanding principal balance | \$ 9,650 | \$ 10,612 |
| Carrying amount | \$ 8,642 | \$ 9,197 |

The following table presents the changes in the accretable yield during the periods for PCI loans (in thousands):

| | Three Months | | Six Months | |
|--|--------------|---------|------------|----------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Balance at beginning of period | \$4,003 | \$2,342 | \$2,480 | \$2,493 |
| Reclassifications (to) from nonaccretable discount | (5) | (235) | 1,814 | 208 |
| Accretion | (240) | (509) | (536) | (1,103) |
| Balance at end of period | \$3,758 | \$1,598 | \$3,758 | \$1,598 |

7. Long-term Obligations

Long-term obligations are summarized as follows (in thousands):

| | June 30, | December 31, |
|---|-----------|--------------|
| | 2017 | 2016 |
| Parent Company | | |
| Subordinated notes: ⁽¹⁾ | | |
| 5.50% Subordinated Notes Due 2026, net of unamortized debt issuance costs ⁽²⁾ | \$98,171 | \$ 98,100 |
| Total Subordinated notes | 98,171 | 98,100 |
| Long-term debt: ⁽³⁾ | | |
| Southside Statutory Trust III Due 2033, net of unamortized debt issuance costs ⁽⁴⁾ | 20,546 | 20,544 |
| Southside Statutory Trust IV Due 2037 ⁽⁵⁾ | 23,196 | 23,196 |
| Southside Statutory Trust V Due 2037 ⁽⁶⁾ | 12,887 | 12,887 |
| Magnolia Trust Company I Due 2035 ⁽⁷⁾ | 3,609 | 3,609 |
| Total Long-term debt | 60,238 | 60,236 |
| Total Parent Company | 158,409 | 158,336 |
| Subsidiaries | | |
| FHLB advances ⁽⁸⁾ | 162,249 | 443,128 |
| Total Subsidiaries | 162,249 | 443,128 |
| Total Long-term obligations | \$320,658 | \$ 601,464 |

(1) This long-term debt consists of subordinated notes with a remaining maturity greater than one year that qualify under the risk-based capital guidelines as Tier 2 capital, subject to certain limitations.

(2) This debt carries a fixed rate of 5.50% through September 29, 2021 and thereafter, adjusts quarterly at a rate equal to three-month LIBOR plus 429.7 basis points.

(3) This long-term debt consists of trust preferred securities that qualify under the risk-based capital guidelines as Tier 1 capital, subject to certain limitations.

(4) This debt carries an adjustable rate of 4.23639% through September 29, 2017 and adjusts quarterly at a rate equal to three-month LIBOR plus 294 basis points.

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- (5) This debt carries an adjustable rate of 2.46956% through July 29, 2017 and adjusts quarterly at a rate equal to three-month LIBOR plus 130 basis points.
- (6) This debt carries an adjustable rate of 3.49556% through September 14, 2017 and adjusts quarterly at a rate equal to three-month LIBOR plus 225 basis points.
- (7) This debt carries an adjustable rate of 2.98644% through August 22, 2017 and adjusts quarterly at a rate equal to three-month LIBOR plus 180 basis points.
- (8) At June 30, 2017, the weighted average cost of these advances was 1.8%. Long-term FHLB advances have maturities ranging from July 2018 through July 2028.

On September 19, 2016, the Company issued \$100.0 million aggregate principal amount of fixed-to-floating rate subordinated notes that mature on September 30, 2026. This debt initially bears interest at a fixed rate of 5.50% through September 29, 2021 and thereafter, adjusts quarterly at a floating rate equal to three-month LIBOR plus 429.7 basis points. The proceeds from the sale of the subordinated notes were used for general corporate purposes, which included advances to the Bank to finance its activities. The unamortized discount and debt issuance costs reflected in the carrying amount of the subordinated notes totaled approximately \$1.8 million at June 30, 2017 and \$1.9 million at December 31, 2016.

The unamortized debt issuance costs reflected in the carrying amount of the Southside Statutory Trust III junior subordinated debentures totaled \$73,000 at June 30, 2017 and \$75,000 at December 31, 2016.

From time to time, the Company may enter into various variable rate advances with the FHLB. These advances totaled \$280.0 million at June 30, 2017 and \$250.0 million at December 31, 2016. Two of the variable rate advances have interest rates of three-month LIBOR minus 25 basis points. The remaining advances have interest rates ranging from one-month LIBOR plus 0.17% to one-month LIBOR plus 0.278%. In connection with obtaining these advances, the Company entered into various interest rate swap contracts that are treated as cash flow hedges under ASC Topic 815, "Derivatives and Hedging" that effectively converted the variable rate advances to fixed interest rates ranging from 0.932% to 2.345% and original terms ranging from five years to ten years. The cash flows from the swaps are expected to be effective in hedging the variability in future cash flows attributable to fluctuations in the one-month and three-month LIBOR interest rates. During the first quarter of 2017, we terminated two interest rate swap contracts designated as cash flow hedges having a total notional value of \$40.0 million. At the time of termination, we determined that the underlying hedged forecasted transactions were still probable of occurring. These transactions are reevaluated on a monthly basis thereafter, to determine if the hedged forecasted transactions are still probable of occurring. If at a subsequent evaluation, it is determined that the transactions will not occur, any related gains or losses recorded in AOCI are immediately recognized in earnings. Refer to "Note 10 - Derivative Financial Instruments and Hedging Activities" in our consolidated financial statements included in this report for a detailed description of our hedging policy and methodology related to derivative instruments.

8. Employee Benefit Plans

The components of net periodic benefit cost (income) are as follows (in thousands):

| | | Three Months Ended June 30, | | | |
|------|------|-----------------------------|--------------|-------------|------|
| | | Defined | | Restoration | |
| | | Benefit | Benefit | Plan | |
| | | Pension Plan | Pension Plan | Plan | |
| | | Acquired | | | |
| 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |

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| | | | | | | |
|--|---------|---------|-------|--------|-------|-------|
| Service cost | \$341 | \$316 | \$— | \$— | \$73 | \$56 |
| Interest cost | 888 | 953 | 44 | 53 | 151 | 133 |
| Expected return on assets | (1,513) | (1,257) | (53) | (66) | — | — |
| Net loss amortization | 312 | 462 | — | — | 104 | 40 |
| Prior service (credit) cost amortization | (3) | 7 | — | — | 1 | 1 |
| Special and contractual termination benefits | — | 29 | — | — | — | — |
| Net periodic benefit cost (income) | \$25 | \$510 | \$(9) | \$(13) | \$329 | \$230 |

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| | Six Months Ended June 30, | | | | | |
|--|------------------------------|---------|---------------------------------------|--------|------------------|-------|
| | Defined Benefit Pension Plan | | Defined Benefit Pension Plan Acquired | | Restoration Plan | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Service cost | \$699 | \$684 | \$— | \$— | \$124 | \$103 |
| Interest cost | 1,800 | 1,870 | 89 | 106 | 283 | 268 |
| Expected return on assets | (3,025) | (2,611) | (107) | (133) | — | — |
| Net loss amortization | 656 | 820 | — | — | 151 | 93 |
| Prior service (credit) cost amortization | (7) | 1 | — | — | 3 | 3 |
| Special and contractual termination benefits | — | 1,549 | — | — | — | — |
| Net periodic benefit cost (income) | \$123 | \$2,313 | \$(18) | \$(27) | \$561 | \$467 |

9. Share-based Incentive Plans

2017 Incentive Plan

On May 10, 2017, our shareholders approved the Southside Bancshares, Inc. 2017 Incentive Plan (the “2017 Incentive Plan”), which is a stock-based incentive compensation plan. A total of 2,050,000 shares of our common stock were reserved and available for issuance pursuant to awards granted under the 2017 Incentive Plan, plus a number of additional shares (not to exceed 410,000) underlying awards outstanding as of May 10, 2017 under the Company’s 2009 Incentive Plan that thereafter terminate or expire unexercised, or are cancelled, forfeited or lapse for any reason. Under the 2017 Incentive Plan, we are authorized to grant stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, and qualified performance-based awards or any combination thereof to selected employees, officers, directors and consultants of the Company and its Affiliates.

There have been no awards granted during the six months ended June 30, 2017. During the six months ended June 30, 2016, we granted 87,474 nonqualified stock options (“NQSOs”) pursuant to the 2009 Incentive Plan with an exercise price equal to the fair value of the shares at the date of grant with a weighted average exercise price of \$25.97. The NQSOs have contractual terms of 10 years and vest in equal annual installments over either a three- or four-year period. We also granted 18,315 restricted stock units (“RSUs”) during the six months ended June 30, 2016, with a total value of \$486,000. The RSUs vest in equal annual installments over either a three- or four-year period.

Historically, shares issued in connection with stock compensation awards have been issued from available authorized shares. Beginning in the second quarter of 2017, shares were issued from available treasury shares. Shares issued in connection with stock compensation awards along with other related information were as follows (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|--------|---------------------------|--------|
| | 2017 | 2016 | 2017 | 2016 |
| New shares issued from available authorized shares | 14,715 | 18,256 | 48,311 | 23,168 |
| New shares issued from available treasury shares | 11,767 | — | 11,767 | — |
| Total | 26,482 | 18,256 | 60,078 | 23,168 |

| | | | | |
|--------------------------------------|-------|-------|---------|-------|
| Proceeds from stock option exercises | \$383 | \$159 | \$1,022 | \$194 |
|--------------------------------------|-------|-------|---------|-------|

For the three and six months ended June 30, 2017, we had share-based compensation expense of \$419,000 and \$913,000, respectively. Share-based compensation expense for the three and six months ended June 30, 2016 was \$403,000 and \$758,000, respectively.

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10. Derivative Financial Instruments and Hedging Activities

Our hedging policy allows the use of interest rate derivative instruments to manage our exposure to interest rate risk or hedge specified assets and liabilities. These instruments may include interest rate swaps and interest rate caps and floors. All derivative instruments are carried on the balance sheet at their estimated fair value and are recorded in other assets or other liabilities, as appropriate.

Derivative instruments may be designated as cash flow hedges of variable rate assets or liabilities, or as cash flow hedges of forecasted transactions. Gains and losses on derivative instruments designated as cash flow hedges are recorded in accumulated other comprehensive income to the extent that they are effective. The amount recorded in other comprehensive income is reclassified to earnings in the same periods that the hedged cash flows impact earnings. The ineffective portion of changes in fair value is reported in current earnings.

From time to time, we enter into certain interest rate swap contracts on specific variable-rate advance agreements with the FHLB. These interest rate swap contracts were designated as hedging instruments in cash flow hedges under ASC Topic 815. The objective of the interest rate swap contracts is to manage the expected future cash flows on \$240.0 million of variable-rate advance agreements with the FHLB. The cash flows from the swap are expected to be effective in hedging the variability in future cash flows attributable to fluctuations in the underlying LIBOR interest rate.

In accordance with ASC Topic 815, if a hedging item is terminated prior to maturity for a cash settlement, the existing gain or loss within accumulated other comprehensive income will continue to be reclassified into earnings during the period or periods in which the hedged forecasted transaction affects earnings unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period. If the forecasted transaction is deemed probable to not occur, the derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately. During the first quarter of 2017, we terminated two interest rate swap contracts designated as cash flow hedges. At the time of termination, we determined that the underlying hedged forecasted transactions were still probable of occurring. The existing gain in accumulated other comprehensive income will be reclassified into earnings in the same periods the hedged forecasted transaction affects earnings.

At June 30, 2017, net derivative assets included \$4.8 million of cash collateral received from counterparties under master netting agreements and net derivative liabilities included \$1.1 million of cash collateral held by a counterparty subject to a master netting agreement. At June 30, 2017, we had \$553,000 of cash collateral receivable that was not offset against derivative liabilities.

From time to time, we may enter into certain interest rate swaps, cap, and floor contracts that are not designated as hedging instruments. These interest rate derivative contracts relate to transactions in which we enter into an interest rate swap, cap, or floor with a customer while concurrently entering into an offsetting interest rate swap, cap, or floor with a third-party financial institution. We agree to pay interest to the customer on a notional amount at a variable rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, we agree to pay a third-party financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. These interest rate derivative contracts allow our customers to effectively convert a variable rate loan to a fixed rate loan. The changes in the fair value of the underlying derivative contracts primarily offset each other and do not significantly impact our results of operations. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change. We recognized swap fee income associated with these derivative contracts immediately based upon the difference in the bid/ask spread of the underlying transactions with the customer and the third-party financial institution. The swap fee income is included in other noninterest income in our consolidated statements of income.

The notional amounts of the derivative instruments represent the contractual cash flows pertaining to the underlying agreements. These amounts are not exchanged and are not reflected in the consolidated balance sheets. The fair value of the interest rate swaps are presented at net in other assets and other liabilities when a right of offset exists, based on transactions with a single counterparty that are subject to a legally enforceable master netting agreement.

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The following tables present the notional and estimated fair value amount of derivative positions outstanding for the periods presented (in thousands):

| | June 30, 2017 | | | December 31, 2016 | | |
|---|---------------------------|---------------------|-------------------------|---------------------------|---------------------|-------------------------|
| | Estimated Fair Value | | | Estimated Fair Value | | |
| | Notional Amount (1) | Asset Derivative | Liability Derivative | Notional Amount (1) | Asset Derivative | Liability Derivative |
| Derivatives designated as hedging instruments | | | | | | |
| Interest rate contracts: | | | | | | |
| Swaps-Cash Flow Hedge-Financial institution counterparties | \$240,000 | \$ 6,189 | \$ 344 | \$250,000 | \$ 7,069 | \$ — |
| Derivatives designated as non-hedging instruments | | | | | | |
| Interest rate contracts: | | | | | | |
| Swaps-Financial institution counterparties | 67,942 | 76 | 1,222 | 2,182 | 85 | — |
| Swaps-Customer counterparties | 67,942 | 1,222 | 76 | 2,182 | — | 85 |
| Gross derivatives | | 7,487 | 1,642 | | 7,154 | 85 |
| Offsetting derivative assets/liabilities | | (420) | (420) | | — | — |
| Cash collateral received/posted | | (4,760) | (1,146) | | (7,154) | — |
| Net derivatives included in the consolidated balance sheets (2) | | \$ 2,307 | \$ 76 | | \$ — | \$ 85 |

Notional amounts, which represent the extent of involvement in the derivatives market, are used to determine the contractual cash flows required in accordance with the terms of the agreement. These amounts are typically not exchanged, significantly exceed amounts subject to credit or market risk, and are not reflected in the consolidated balance sheets.

Net derivative assets are included in “other assets” and net derivative liabilities are included in “other liabilities” on the consolidated balance sheets. Included in the fair value of net derivative assets and net derivative liabilities are credit valuation adjustments reflecting counterparty credit risk and our credit risk. We had net credit exposure of \$1.6 million related to interest rate swaps with financial institutions and \$1.2 million related to interest rate swaps with customers at June 30, 2017. The credit risk associated with customer transactions is partially mitigated as these transactions are generally secured by the non-cash collateral securing the underlying transaction being hedged. We had no credit exposure related to interest rate swaps with financial or customer counterparties at December 31, 2016.

The summarized expected weighted average remaining maturity of the notional amount of interest rate swaps and the weighted average interest rates associated with the amounts expected to be received or paid on interest rate swap agreements are presented below (dollars in thousands). Variable rates received on pay fixed swaps are based on one-month or three-month LIBOR rates in effect at June 30, 2017 and December 31, 2016:

| | June 30, 2017 | | | December 31, 2016 | | |
|--|--------------------|---|---------------------|--------------------|---|---------------------|
| | Notional Amount | Weighted Average Remaining Maturity (in years) | Receive Pay Rate | Notional Amount | Weighted Average Remaining Maturity (in years) | Receive Pay Rate |
| Swaps-Cash Flow Hedge Financial institution counterparties | \$240,000 | 5.8 | 1.14 % 1.43 % | \$250,000 | 5.4 | 0.68 % 1.31 % |
| Swaps-Non-Hedging Financial institution counterparties | 67,942 | 13.2 | 1.04 2.37 | 2,182 | 9.7 | 0.62 1.57 |

| | | | | | | | | |
|-------------------------|--------|------|------|------|-------|-----|------|------|
| Customer counterparties | 67,942 | 13.2 | 2.37 | 1.04 | 2,182 | 9.7 | 1.57 | 0.62 |
|-------------------------|--------|------|------|------|-------|-----|------|------|

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11. Fair Value Measurement

Fair value is 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 is not 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.

Valuation techniques including the market approach, the income approach and/or the cost approach are utilized to determine fair value. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Valuation policies and procedures are determined by our investment department and reported to our Asset/Liability Committee (“ALCO”) for review. An entity must consider all aspects of nonperforming risk, including the entity’s own credit standing, when measuring fair value of a 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. A fair value hierarchy for valuation inputs 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 might 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 (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Level 3 assets recorded at fair value on a nonrecurring basis at June 30, 2017 and December 31, 2016, included loans for which a specific allowance was established based on the fair value of collateral and commercial real estate for which fair value of the properties was less than the cost basis. For both asset classes, the unobservable inputs were the additional adjustments applied by management to the appraised values to reflect such factors as non-current appraisals and revisions to estimated time to sell. These adjustments are determined based on qualitative judgments made by management on a case-by-case basis and are not quantifiable inputs, although they are used in the determination of fair value.

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.

Certain financial assets are measured at fair value in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of fair value accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with our monthly and/or quarterly valuation process. There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2017 or the year ended December 31, 2016.

Securities Available for Sale – U.S. Treasury securities and other equity securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, we obtain fair value measurements from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things.

We review the prices supplied by the independent pricing services for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In addition, we obtain an understanding of their underlying pricing methodologies and their Statement on Standards for Attestation Engagements-Reporting on Controls of a Service Organization (“SSAE 16”). We validate prices supplied by the independent pricing services by comparison to prices obtained from, in most cases, three additional third

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party sources. For securities where prices are outside a reasonable range, we further review those securities to determine what a reasonable price estimate is for that security, given available data.

Derivatives – Derivatives are reported at fair value utilizing Level 2 inputs. We obtain fair value measurements from three sources including an independent pricing service and the counterparty to the derivatives designated as hedges. The fair value measurements consider observable data that may include dealer quotes, market spreads, the U.S. Treasury yield curve, live trading levels, trade execution data, credit information and the derivatives' terms and conditions, among other things. We review the prices supplied by the sources for reasonableness. In addition, we obtain a basic understanding of their underlying pricing methodology. We validate prices supplied by the sources by comparison to one another.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, which means that 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 nonrecurring basis included foreclosed assets and impaired loans at June 30, 2017 and December 31, 2016.

Foreclosed Assets – Foreclosed assets are initially recorded at fair value less costs to sell. The fair value measurements of foreclosed assets can include Level 2 measurement inputs such as real estate appraisals and comparable real estate sales information, in conjunction with Level 3 measurement inputs such as cash flow projections, qualitative adjustments, and sales cost estimates. As a result, the categorization of foreclosed assets is Level 3 of the fair value hierarchy. In connection with the measurement and initial recognition of certain foreclosed assets, we may recognize charge-offs through the allowance for loan losses.

Impaired Loans – Certain impaired loans may be reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria or appraisals. At June 30, 2017 and December 31, 2016, the impact of loans with specific reserves based on the fair value of the collateral was reflected in our allowance for loan losses.

Certain nonfinancial assets and nonfinancial liabilities measured at fair value on a recurring basis include reporting units measured at fair value and tested for goodwill impairment.

The following tables summarize assets measured at fair value on a recurring and nonrecurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

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| | As of June 30, 2017 | | | |
|---|---------------------|---|---|---|
| | Carrying Amount | Fair Value Measurements at the End of the Reporting Period Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Recurring fair value measurements | | | | |
| Investment Securities: | | | | |
| State and Political Subdivisions | \$326,159 | \$— | \$326,159 | \$— |
| Other Stocks and Bonds | 5,144 | — | 5,144 | — |
| Other Equity Securities | 5,954 | 5,954 | — | — |
| Mortgage-backed Securities: ⁽¹⁾ | | | | |
| Residential | 654,104 | — | 654,104 | — |
| Commercial | 406,450 | — | 406,450 | — |
| Derivative assets: | | | | |
| Interest rate swaps | 7,487 | — | 7,487 | — |
| Total asset recurring fair value measurements | \$1,405,298 | \$5,954 | \$1,399,344 | \$— |
| Derivative liabilities: | | | | |
| Interest rate swaps | \$1,642 | \$— | \$1,642 | \$— |
| Total liability recurring fair value measurements | \$1,642 | \$— | \$1,642 | \$— |
| Nonrecurring fair value measurements | | | | |
| Foreclosed assets | \$247 | \$— | \$— | \$247 |
| Impaired loans ⁽²⁾ | 6,785 | — | — | 6,785 |
| Total asset nonrecurring fair value measurements | \$7,032 | \$— | \$— | \$7,032 |

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| | As of December 31, 2016 | | | |
|---|-------------------------|---|---|--|
| | | Fair Value Measurements at the End of the Reporting Period Using | | |
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | Carrying Amount | | | |
| Recurring fair value measurements | | | | |
| Investment Securities: | | | | |
| U.S. Treasury | \$70,069 | \$70,069 | \$— | \$ — |
| State and Political Subdivisions | 385,197 | — | 385,197 | — |
| Other Stocks and Bonds | 6,651 | — | 6,651 | — |
| Other Equity Securities | 5,920 | 5,920 | — | — |
| Mortgage-backed Securities: ⁽¹⁾ | | | | |
| Residential | 627,508 | — | 627,508 | — |
| Commercial | 384,255 | — | 384,255 | — |
| Derivative assets: | | | | |
| Interest rate swaps | 7,154 | — | 7,154 | — |
| Total asset recurring fair value measurements | \$1,486,754 | \$75,989 | \$1,410,765 | \$ — |
| Derivative liabilities: | | | | |
| Interest rate swaps | \$85 | \$— | \$85 | \$ — |
| Total liability recurring fair value measurements | \$85 | \$— | \$85 | \$ — |
| Nonrecurring fair value measurements | | | | |
| Foreclosed assets | \$388 | \$— | \$— | \$ 388 |
| Impaired loans ⁽²⁾ | 9,693 | — | — | 9,693 |
| Total asset nonrecurring fair value measurements | \$10,081 | \$— | \$— | \$ 10,081 |

(1) All mortgage-backed securities are issued and/or guaranteed by U.S. government agencies or U.S. government-sponsored enterprises.

(2) Impaired loans represent collateral-dependent loans with a specific valuation allowance. Losses on these loans represent charge-offs which are netted against the allowance for loan losses.

Disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, is required when it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Such techniques and assumptions, as they apply to individual categories of our financial instruments, are as follows:

Cash and cash equivalents - The carrying amount for cash and cash equivalents is a reasonable estimate of those assets' fair value.

Investment and mortgage - backed securities held to maturity - Fair values for these securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices for similar securities or estimates from independent pricing services.

FHLB stock and other investments - The carrying amount of FHLB stock and other investments is a reasonable estimate of the fair value of those assets.

Loans receivable - For adjustable rate loans that reprice frequently and with no significant change in credit risk, the carrying amounts are a reasonable estimate of those assets' fair value. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Nonperforming loans are estimated using discounted cash flow analyses or the underlying value of the collateral where applicable.

Loans held for sale – The fair value of loans held for sale is determined based on expected proceeds, which are based on sales contracts and commitments.

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Deposit liabilities - The fair value of demand deposits, savings accounts, and certain money market deposits is the amount on demand at the reporting date, which is the carrying value. Fair values for fixed rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities.

Federal funds purchased and repurchase agreements - Federal funds purchased generally have original terms to maturity of one day and repurchase agreements generally have terms of less than one year, and therefore both are considered short-term borrowings. Consequently, their carrying value is a reasonable estimate of fair value.

FHLB advances - The fair value of these advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities.

Subordinated notes - The fair value of the subordinated notes is estimated by discounting future cash flows using estimated rates at which long-term debt would be made to borrowers with similar credit ratings and for the remaining maturities.

Long-term debt - The fair value of the long-term debt is estimated by discounting future cash flows using estimated rates at which long-term debt would be made to borrowers with similar credit ratings and for the remaining maturities.

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The following tables present our financial assets, financial liabilities, and unrecognized financial instruments measured on a nonrecurring basis at both their respective carrying amounts and estimated fair value (in thousands):

| June 30, 2017 | Carrying Amount | Estimated Fair Value | | | |
|--|-----------------|----------------------|-----------|-------------|-----------|
| | | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$235,832 | \$235,832 | \$235,832 | \$— | \$ — |
| Investment Securities: | | | | | |
| Held to maturity, at carrying value | 419,825 | 430,155 | — | 430,155 | — |
| Mortgage-backed Securities: | | | | | |
| Held to maturity, at carrying value | 505,713 | 513,621 | — | 513,621 | — |
| FHLB stock, at cost, and other investments | 66,985 | 66,985 | — | 66,985 | — |
| Loans, net of allowance for loan losses | 2,590,957 | 2,603,697 | — | — | 2,603,697 |
| Loans held for sale | 3,036 | 3,036 | — | 3,036 | — |
| Financial Liabilities: | | | | | |
| Deposits | \$3,624,073 | \$3,620,875 | \$— | \$3,620,875 | \$ — |
| Federal funds purchased and repurchase agreements | 8,424 | 8,424 | — | 8,424 | — |
| FHLB advances | 1,178,082 | 1,172,459 | — | 1,172,459 | — |
| Subordinated notes, net of unamortized debt issuance costs | 98,171 | 102,771 | — | 102,771 | — |
| Long-term debt, net of unamortized debt issuance costs | 60,238 | 47,897 | — | 47,897 | — |

| December 31, 2016 | Carrying Amount | Estimated Fair Value | | | |
|--|-----------------|----------------------|-----------|-------------|-----------|
| | | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$169,654 | \$169,654 | \$169,654 | \$— | \$ — |
| Investment Securities: | | | | | |
| Held to maturity, at carrying value | 425,810 | 429,912 | — | 429,912 | — |
| Mortgage-backed Securities: | | | | | |
| Held to maturity, at carrying value | 511,677 | 514,370 | — | 514,370 | — |
| FHLB stock, at cost, and other investments | 66,592 | 66,592 | — | 66,592 | — |
| Loans, net of allowance for loan losses | 2,538,626 | 2,630,009 | — | — | 2,630,009 |
| Loans held for sale | 7,641 | 7,641 | — | 7,641 | — |
| Financial Liabilities: | | | | | |
| Deposits | \$3,533,076 | \$3,293,352 | \$— | \$3,293,352 | \$ — |
| Federal funds purchased and repurchase agreements | 7,097 | 7,097 | — | 7,097 | — |
| FHLB advances | 1,309,646 | 1,331,517 | — | 1,331,517 | — |
| Subordinated notes, net of unamortized debt issuance costs | 98,100 | 101,627 | — | 101,627 | — |
| Long-term debt, net of unamortized debt issuance costs | 60,236 | 45,147 | — | 45,147 | — |

The fair value estimate of financial instruments for which quoted market prices are unavailable is dependent upon the assumptions used. Consequently, those estimates cannot be substantiated by comparison to independent markets and, in many cases, could

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not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented in the above fair value table do not necessarily represent their underlying value.

12. Income Taxes

The income tax expense included in the accompanying statements of income consists of the following (in thousands):

| | Three Months | | Six Months | |
|---------------------------------------|--------------|---------|------------|---------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Current income tax expense | \$3,317 | \$1,454 | \$6,344 | \$5,239 |
| Deferred income tax (benefit) expense | 36 | 1,318 | 17 | 506 |
| Income tax expense | \$3,353 | \$2,772 | \$6,361 | \$5,745 |

Net deferred tax assets totaled \$22.4 million at June 30, 2017 and \$28.9 million at December 31, 2016. No valuation allowance for deferred tax assets was recorded at June 30, 2017 or December 31, 2016, as management believes it is more likely than not that all of the deferred tax assets will be realized in future years. Unrecognized tax benefits were not material at June 30, 2017 or December 31, 2016.

During the first quarter of 2017, we adopted a new accounting standard that impacted how the income tax effects associated with stock-based compensation are recognized. See “Note 1 - Summary of Significant Accounting and Reporting Policies” for additional information.

We recognized income tax expense of \$3.4 million and \$6.4 million, for an effective tax rate (“ETR”) of 18.8% and 17.8% for the three and six months ended June 30, 2017, respectively, compared to income tax expense of \$2.8 million and \$5.7 million, for an ETR of 19.6% and 18.7%, for the three and six months ended June 30, 2016, respectively. The lower ETR for the three and six months ended June 30, 2017 was mainly due to the adoption of the accounting standard mentioned above, reducing income tax expense by \$84,000 and \$210,000 and the ETR by 0.5% and 0.6%, respectively. The ETR differs from the stated rate of 35% during the comparable period primarily due to the effect of tax-exempt income from municipal loans and securities, as well as bank owned life insurance. We file federal income tax returns and certain state tax returns. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2013.

13. Off-Balance-Sheet Arrangements, Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, we are a party to certain financial instruments with off-balance-sheet risk to meet the financing needs of our customers. These off-balance-sheet instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount reflected in the financial statements. The contract or notional amounts of these instruments reflect the extent of involvement and exposure to credit loss that we have in these particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require the payment of fees. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in

extending loan commitments to customers and similarly do not necessarily represent future cash obligations.

Financial instruments with off-balance-sheet risk were as follows (in thousands):

| | At June 30, 2017 | At December 31, 2016 |
|------------------------------|------------------------|-------------------------------|
| Unused commitments: | | |
| Commitments to extend credit | \$693,485 | \$ 665,663 |
| Standby letters of credit | 9,818 | 9,075 |
| Total | \$703,303 | \$ 674,738 |

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We apply the same credit policies in making commitments and standby letters of credit as we do for on-balance-sheet instruments. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include cash or cash equivalents, negotiable instruments, real estate, accounts receivable, inventory, oil, gas and mineral interests, property, plant, and equipment.

Lease Commitments. We lease certain branch facilities and office equipment under operating leases. It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

Securities. In the normal course of business we buy and sell securities. There were \$24.9 million and \$160,000 of unsettled trades to purchase securities at June 30, 2017 and December 31, 2016, respectively. There were no unsettled trades to sell securities as of June 30, 2017 or December 31, 2016.

Deposits. There were no unsettled issuances of brokered CDs at June 30, 2017 or December 31, 2016.

Litigation. We are a party to various litigation in the normal course of business. Management, after consulting with our legal counsel, believes that any liability resulting from litigation will not have a material effect on our financial position, results of operations or liquidity.

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ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our consolidated financial condition, changes in our financial condition, and results of our operations, and should be read and reviewed in conjunction with the financial statements, and the notes thereto, in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2016.

Forward-Looking Statements

Certain statements of other than historical fact that are contained in this report may be considered to be “forward-looking statements” within the meaning of and subject to the safe harbor protections of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management’s views as of any subsequent date. These statements may include words such as “expect,” “estimate,” “project,” “anticipate,” “appear,” “believe,” “could,” “should,” “may,” “will,” “would,” “intend,” “probability,” “risk,” “goal,” “objective,” “plans,” “potential,” and similar expressions. Forward-looking statements are statements with respect to our beliefs, plans, expectations, objectives, goals, anticipations, assumptions and estimates about our future performance and are subject to significant known and unknown risks and uncertainties, which could cause our actual results to differ materially from the results discussed in the forward-looking statements. For example, discussions about trends in asset quality, capital, liquidity, the pace of loan and revenue growth, the Company’s ability to sell nonperforming assets, expense reductions, planned operational efficiencies, earnings and certain market risk disclosures, including the impact of interest rates and other economic factors, are based upon information presently available to management and are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and could be materially different from what actually occurs in the future. Accordingly, our results could materially differ from those that have been estimated. Other factors that could cause actual results to differ materially from those indicated by forward-looking statements include, but are not limited to, the following:

- general economic conditions, either globally, nationally, in the State of Texas, or in the specific markets in which we operate, including, without limitation, the deterioration of the commercial real estate, residential real estate, construction and development, energy, oil, and gas credit and liquidity markets, which could cause an adverse change in our net interest margin, or a decline in the value of our assets, which could result in realized losses;
- current or future legislation, regulatory changes or changes in monetary or fiscal policy that adversely affect the businesses in which we are engaged, including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), the Federal Reserve’s actions with respect to interest rates, the capital requirements promulgated by the Basel Committee on Banking Supervision (“Basel Committee”) and other regulatory responses to economic conditions;
- adverse changes in the status or financial condition of the Government-Sponsored Enterprises (the “GSEs”) which impact the GSEs’ guarantees or ability to pay or issue debt;
- adverse changes in the credit portfolio of other U.S. financial institutions relative to the performance of certain of our investment securities;
- economic or other disruptions caused by acts of terrorism in the United States, Europe or other areas;
- changes in the interest rate yield curve such as flat, inverted or steep yield curves, or changes in the interest rate environment that impact interest margins and may impact prepayments on our mortgage-backed securities (“MBS”) portfolio;
- increases in our nonperforming assets;
- our ability to maintain adequate liquidity to fund operations and growth;
- any applicable regulatory limits or other restrictions on Southside Bank’s ability to pay dividends to us;
- the failure of our assumptions underlying allowance for loan losses and other estimates;
- the effectiveness of our derivative financial instruments and hedging activities to manage risk;
- unexpected outcomes of, and the costs associated with, existing or new litigation involving us;
- changes impacting our balance sheet and leverage strategy;
- risks related to actual mortgage prepayments diverging from projections;

- risks related to actual U.S. Agency MBS prepayments exceeding projected prepayment levels;
- risks related to U.S. Agency MBS prepayments increasing due to U.S. Government programs designed to assist homeowners to refinance their mortgage that might not otherwise have qualified;
- our ability to monitor interest rate risk;

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risks related to the price per barrel of crude oil;

significant increases in competition in the banking and financial services industry;

changes in consumer spending, borrowing and saving habits;

technological changes, including potential cyber-security incidents;

execution of future acquisition, reorganization or disposition transactions, including the risk that the anticipated benefits of such transactions are not realized;

our ability to increase market share and control expenses;

our ability to develop competitive new products and services in a timely manner and the acceptance of such products and services by our customers;

the effect of changes in federal or state tax laws;

the effect of compliance with legislation or regulatory changes;

the effect of changes in accounting policies and practices;

credit risks of borrowers, including any increase in those risks due to changing economic conditions;

risks related to loans secured by real estate, including the risk that the value and marketability of collateral could decline; and

other risks and uncertainties discussed in Part I - "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2016.

All written or oral forward-looking statements made by us or attributable to us are expressly qualified by this cautionary notice. We disclaim any obligation to update any factors or to announce publicly the result of revisions to any of the forward-looking statements included herein to reflect future events or developments, unless otherwise required by law.

Critical Accounting Estimates

Our accounting and reporting estimates conform with U.S. generally accepted accounting principles ("GAAP") and general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. We consider our critical accounting policies to include the following:

Allowance for Losses on Loans. The allowance for losses on loans represents our best estimate of probable losses inherent in the existing loan portfolio. The allowance for losses on loans is increased by the provision for losses on loans charged to expense and reduced by loans charged-off, net of recoveries. The provision for losses on loans is determined based on our assessment of several factors: reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on specific borrowers and industry groups, historical loan loss experience, the level of classified and nonperforming loans and the results of regulatory examinations.

The allowance for loan loss is based on the most current review of the loan portfolio and is a result of multiple processes. The servicing officer has the primary responsibility for updating significant changes in a customer's financial position. Each officer prepares status updates on any credit deemed to be experiencing repayment difficulties which, in the officer's opinion, would place the collection of principal or interest in doubt. Our internal loan review department is responsible for an ongoing review of our loan portfolio with specific goals set for the loans to be reviewed on an annual basis.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If full collection of the loan balance appears unlikely at the time of review, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to determine the necessary allowances. The internal loan review department maintains a list of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$150,000 or more is updated on a quarterly basis

in order to properly determine the necessary allowance and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The measurement of loss on impaired loans is generally based on the fair value of the collateral if repayment is expected solely from the collateral or the present value of the expected future cash flows discounted at the historical effective interest rate stipulated in the loan agreement. In measuring the fair value of the collateral, in addition to relying on third party appraisals, we use assumptions such

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as discount rates and methodologies, comparisons to recent sales prices of similar assets, and other assumptions consistent with those that would be utilized by unrelated third parties performing a valuation.

Changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the conditions of the various markets in which collateral may be sold all may affect the required level of the allowance for losses on loans and the associated provision for loan losses.

The allowance for loan losses related to purchase credit impaired (“PCI”) loans is based on an analysis that is performed quarterly to estimate the expected cash flows for each loan deemed PCI. To the extent that the expected cash flows from a PCI loan have decreased since the acquisition date, we establish or increase the allowance for loan losses.

For acquired loans that are not deemed credit impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans. The remaining differences between the purchase price and the unpaid principal balance at the date of acquisition are recorded in interest income over the economic life of the loan.

As of June 30, 2017, our review of the loan portfolio indicated that a loan loss allowance of \$19.2 million was appropriate to cover probable losses in the portfolio.

Refer to “Part II - Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Loan Loss Experience and Allowance for Loan Losses” and “Note 6 – Loans and Allowance for Probable Loan Losses” in our Annual Report on Form 10-K for the year ended December 31, 2016 for a detailed description of our estimation process and methodology related to the allowance for loan losses.

Estimation of Fair Value. The estimation of fair value is significant to a number of our assets and liabilities. In addition, GAAP requires disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values for securities are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves. Fair values for most investment and MBS 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 estimates from independent pricing services. Where there are price variances outside certain ranges from different pricing services for specific securities, those pricing variances are reviewed with other market data to determine which of the price estimates is appropriate for that period. Fair values for our derivatives are based on measurements that consider observable data that may include dealer quotes, market spreads, the U.S. Treasury yield curve, live trading levels, trade execution data, credit information, and the derivatives’ terms and conditions, among other things. We validate prices supplied by the sources by comparison to one another.

Impairment of Investment Securities and Mortgage-backed Securities. Investment securities and MBS classified as available for sale (“AFS”) are carried at fair value, and the impact of changes in fair value are recorded on our consolidated balance sheet as an unrealized gain or loss in “Accumulated Other Comprehensive (Loss) Income,” a separate component of shareholders’ equity. Securities classified as AFS or held to maturity (“HTM”) are subject to our review to identify when a decline in value is other-than-temporary. When it is determined that a decline in value is other-than-temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings for the credit portion and to other comprehensive income for the noncredit portion. Factors considered in determining whether a decline in value is other-than-temporary include: (1) whether the decline is substantial, the duration of the decline and the reasons for the decline in value; (2) whether the decline is related to a credit event, a change in interest rate or a change in the market discount rate; (3) the financial condition and near-term prospects of the issuer; and (4) whether we have a current intent to sell the security and whether it is not more likely than not that we will be required to sell the security before the anticipated recovery of its amortized cost basis. For certain assets, we consider expected cash flows of the investment in determining if impairment exists.

Defined Benefit Pension Plan. The plan obligations and related assets of our defined benefit pension plan (the “Plan”) and the OmniAmerican Bank Defined Benefit Plan (the “Acquired Plan”) are described in “Note 11 – Employee Benefits” in our Annual Report on Form 10-K for the year ended December 31, 2016. Entry into the Plan by new employees was frozen effective December 31, 2005. Effective December 31, 2006, employee benefits under the Acquired Plan

were frozen by Omni. In addition, no new participants may be added to the Acquired Plan. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using observable market quotations. Plan obligations and the annual pension expense are determined by independent actuaries and through the use of a number of assumptions that are reviewed by management. Key assumptions in measuring the Plan obligations include the discount rate, the rate of salary increases and the estimated future return on Plan assets. In determining the discount rate, we utilized a cash flow matching analysis to determine a range of appropriate discount rates for our defined benefit pension and restoration plans. In developing the cash flow matching analysis, we constructed a portfolio of high quality noncallable bonds (rated AA- or better) to match as close as possible the timing of future benefit payments of the Plans at December 31, 2016. Based on this cash flow matching analysis, we were able to determine an appropriate discount rate.

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Salary increase assumptions are based upon historical experience and our anticipated future actions. The expected long-term rate of return assumption reflects the average return expected based on the investment strategies and asset allocation on the assets invested to provide for the Plan's liabilities. We consider broad equity and bond indices, long-term return projections, and actual long-term historical Plan performance when evaluating the expected long-term rate of return assumption. At June 30, 2017, the weighted-average actuarial assumptions of the Plan were: a discount rate of 4.23%; assumed salary increases of 3.50%; and a long-term rate of return on Plan assets of 7.25%. Material changes in pension benefit costs may occur in the future due to changes in these assumptions. Future annual amounts could be impacted by changes in the number of Plan participants, changes in the level of benefits provided, changes in the discount rates, changes in the expected long-term rate of return, changes in the level of contributions to the Plan and other factors.

Non-GAAP Financial Measures

Certain non-GAAP measures are used by management to supplement the evaluation of our performance. These include the following fully-taxable equivalent measures: tax-equivalent net interest income, tax-equivalent net interest margin, and tax-equivalent net interest spread, which include the effects of taxable-equivalent adjustments using a federal income tax rate of 35% to increase tax-exempt interest income to a tax-equivalent basis. Whenever we present a non-GAAP financial measure in an SEC filing, we are also required to present the most directly comparable financial measure calculated and presented in accordance with GAAP and reconcile the differences between the non-GAAP financial measure and such comparable GAAP measure. Tax-equivalent adjustments are reported in notes 2 and 3 to the "Average Balances with Average Yields and Rates" tables under "Results of Operations."

Tax-equivalent net interest income, net interest margin and net interest spread. Net interest income on a tax-equivalent basis is a non-GAAP measure that adjusts for the tax-favored status of net interest income from loans and investments. We believe this measure to be the preferred industry measurement of net interest income and it enhances comparability of net interest income arising from taxable and tax-exempt sources. The most directly comparable financial measure calculated in accordance with GAAP is our net interest income. Net interest margin on a tax-equivalent basis is net interest income on a tax-equivalent basis divided by average interest-earning assets on a tax-equivalent basis. The most directly comparable financial measure calculated in accordance with GAAP is our net interest margin. Net interest spread on a tax-equivalent basis is the difference in the average yield on average interest-earning assets on a tax equivalent basis and the average rate paid on average interest-bearing liabilities. The most directly comparable financial measure calculated in accordance with GAAP is our net interest spread.

These non-GAAP financial measures should not be considered an alternative to GAAP-basis financial statements, and other bank holding companies may define or calculate these or similar measures differently.

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Off-Balance-Sheet Arrangements, Commitments and Contingencies

Financial Instruments with Off-Balance-Sheet Risk. In the normal course of business, we are a party to certain financial instruments with off-balance-sheet risk to meet the financing needs of our customers. These off-balance-sheet instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount reflected in the financial statements. The contract or notional amounts of these instruments reflect the extent of involvement and exposure to credit loss that we have in these particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require the payment of fees. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers and similarly do not necessarily represent future cash obligations.

Financial instruments with off-balance-sheet risk were as follows (in thousands):

| | At June 30, 2017 | At December 31, 2016 |
|------------------------------|------------------------|-------------------------------|
| Unused commitments: | | |
| Commitments to extend credit | \$693,485 | \$ 665,663 |
| Standby letters of credit | 9,818 | 9,075 |
| Total | \$703,303 | \$ 674,738 |

We apply the same credit policies in making commitments and standby letters of credit as we do for on-balance-sheet instruments. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include cash or cash equivalents, negotiable instruments, real estate, accounts receivable, inventory, oil, gas and mineral interests, property, plant, and equipment.

Lease Commitments. We lease certain branch facilities and office equipment under operating leases. It is expected that certain leases will be renewed, or equipment replaced with new leased equipment, as these leases expire.

Securities. In the normal course of business we buy and sell securities. There were \$24.9 million and \$160,000 of unsettled trades to purchase securities at June 30, 2017 and December 31, 2016, respectively. There were no unsettled trades to sell securities at June 30, 2017 or December 31, 2016.

Deposits. There were no unsettled issuances of brokered CDs at June 30, 2017 or December 31, 2016.

Litigation. We are a party to various litigation in the normal course of business. Management, after consulting with our legal counsel, believes that any liability resulting from litigation will not have a material effect on our financial position, results of operations or liquidity.

OVERVIEW

Operating Results

During the three months ended June 30, 2017, our net income increased \$3.1 million, or 27.1%, to \$14.5 million from \$11.4 million for the same period in 2016. The increase was the result of a \$4.9 million increase in interest income, a \$2.4 million decrease in provision for loan losses, and a \$0.3 million decrease in noninterest expense, partially offset by a \$3.9 million increase in interest expense and a \$0.6 million increase in income tax expense. Earnings per diluted common share increased \$0.07, or 16.7%, to \$0.49 for the three months ended June 30, 2017, from \$0.42 for the same period in 2016.

During the six months ended June 30, 2017, our net income increased \$4.6 million, or 18.3%, to \$29.5 million from \$24.9 million for the same period in 2016. The increase was the result of a \$6.8 million increase in interest income, a \$3.8 million decrease in noninterest expense, and a \$3.6 million decrease in provision for loan losses, partially offset by a \$7.1 million increase in interest

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expense, and \$2.0 million decrease in noninterest income and a \$0.6 million increase in income tax expense. Earnings per diluted common share increased \$0.08, or 8.7%, to \$1.00 for the six months ended June 30, 2017, from \$0.92 for the same period in 2016.

Financial Condition

Our total assets increased \$14.7 million, or 0.3%, to \$5.58 billion at June 30, 2017 from \$5.56 billion at December 31, 2016 primarily as a result of increases in our loan portfolio and cash and cash equivalents partially offset by decreases in our securities portfolio and deferred tax asset. Loans increased \$53.7 million, or 2.1%, to \$2.61 billion compared to \$2.56 billion at December 31, 2016. The net increase in our loans was comprised of increases of \$87.7 million in commercial real estate loans, \$6.7 million of construction loans, and \$6.4 million of municipal loans, which were partially offset by decreases of \$21.8 million of 1-4 family residential loans, \$20.3 million of loans to individuals, and \$5.0 million of commercial loans. Our securities portfolio decreased by \$93.7 million, or 3.9%, to \$2.32 billion, compared to \$2.42 billion at December 31, 2016. Net deferred tax asset totaled \$22.4 million at June 30, 2017, as compared to \$28.9 million at December 31, 2016. The \$6.5 million decrease in deferred tax assets was due primarily to the decrease in the unrealized losses in the AFS securities portfolio.

Our nonperforming assets at June 30, 2017 decreased 39.3%, to \$9.2 million and represented 0.16% of total assets, compared to \$15.1 million, or 0.27% of total assets at December 31, 2016. Nonaccruing loans decreased \$5.2 million, or 63.4%, to \$3.0 million and the ratio of nonaccruing loans to total loans decreased to 0.12% at June 30, 2017 compared to 0.32% at December 31, 2016. Other Real Estate Owned (“OREO”) decreased to \$233,000 at June 30, 2017 from \$339,000 at December 31, 2016. Repossessed assets decreased to \$14,000 at June 30, 2017 from \$49,000 at December 31, 2016. Restructured loans were \$5.9 million at June 30, 2017, a decrease from \$6.4 million at December 31, 2016.

Our deposits increased \$91.0 million, or 2.6%, to \$3.62 billion at June 30, 2017 from \$3.53 billion at December 31, 2016. The increase in our deposits during 2017 was the result of the increase in brokered CDs. For the six months ended June 30, 2017, our non-interest bearing deposits increased \$53.3 million and interest bearing deposits increased \$37.7 million. Total FHLB advances decreased \$131.6 million to \$1.18 billion at June 30, 2017 from \$1.31 billion at December 31, 2016. Short-term FHLB advances increased \$149.3 million to \$1.02 billion at June 30, 2017 from \$866.5 million at December 31, 2016. Long-term FHLB advances decreased \$280.9 million to \$162.2 million at June 30, 2017 from \$443.1 million at December 31, 2016.

Shareholders’ equity at June 30, 2017 totaled \$547.1 million compared to \$518.3 million at December 31, 2016. The 5.6% increase was primarily the result of net income of \$29.5 million recorded for the six months ended June 30, 2017, a decrease in accumulated other comprehensive loss of \$11.9 million, stock compensation expense of \$913,000, net issuance of common stock under employee stock plans of \$890,000 and common stock issued under our dividend reinvestment plan of \$721,000. These increases were partially offset by cash dividends paid of \$15.2 million.

Key financial indicators management follows include, but are not limited to, numerous interest rate sensitivity and interest rate risk indicators, credit risk, operations risk, liquidity risk, capital risk, regulatory risk, competition risk, yield curve risk, U.S. Agency MBS prepayment risk, and economic risk indicators.

Balance Sheet Strategy

We utilize wholesale funding and securities to enhance our profitability and balance sheet composition by determining acceptable levels of credit, interest rate and liquidity risk consistent with prudent capital management. This balance sheet strategy consists of borrowing a combination of long- and short-term funds from the FHLB and, when determined appropriate, issuing brokered CDs. These funds are invested primarily in U.S. Agency MBS, and to a

lesser extent, long-term municipal securities and U.S. Treasury securities. Although U.S. Agency MBS often carry lower yields than traditional mortgage loans and other types of loans we make, these securities generally (i) increase the overall quality of our assets because of either the implicit or explicit guarantees of the U.S. Government, (ii) are more liquid than individual loans and (iii) may be used to collateralize our borrowings or other obligations. While the strategy of investing a substantial portion of our assets in U.S. Agency MBS and municipal securities has historically resulted in lower interest rate spreads and margins, we believe the lower operating expenses and reduced credit risk, combined with the managed interest rate risk of this strategy, have enhanced our overall profitability over the last several years. At this time, we utilize this balance sheet strategy with the goal of enhancing overall profitability by maximizing the use of our capital.

Risks associated with the asset structure we maintain include a lower net interest rate spread and margin when compared to our peers, changes in the slope of the yield curve, which can reduce our net interest rate spread and margin, increased interest rate risk, the length of interest rate cycles, changes in volatility spreads associated with the MBS and municipal securities, the unpredictable nature of MBS prepayments and credit risks associated with the municipal securities. See “Part I - Item 1A. Risk Factors – Risks Related to Our Business” in our Annual Report on Form 10-K for the year ended December 31, 2016, for a discussion of risks related to interest rates. Our asset structure, net interest spread and net interest margin require us to closely

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monitor our interest rate risk. An additional risk is the change in fair value of the AFS securities portfolio as a result of changes in interest rates. Significant increases in interest rates, especially long-term interest rates, could adversely impact the fair value of the AFS securities portfolio, which could also significantly impact our equity capital. Due to the unpredictable nature of MBS prepayments, the length of interest rate cycles, and the slope of the interest rate yield curve, net interest income could fluctuate more than simulated under the scenarios modeled by our ALCO and described under “Item 3. Quantitative and Qualitative Disclosures about Market Risk” in this Quarterly Report on Form 10-Q.

Determining the appropriate size of the balance sheet is one of the critical decisions any bank makes. Our balance sheet is not merely the result of a series of micro-decisions, but rather the size is controlled based on the economics of assets compared to the economics of funding. The current low interest rate environment and investment and economic landscape requires that we monitor the interest rate sensitivity of the assets driving our growth and closely align ALCO objectives accordingly.

The management of our securities portfolio as a percentage of earning assets is guided by the current economics associated with increasing the securities portfolio, changes in our overall loan and deposit levels, and changes in our wholesale funding levels. If adequate quality loan growth is not available to achieve our goal of enhancing profitability by maximizing the use of capital, as described above, then we may purchase additional securities, if appropriate, which may cause securities as a percentage of earning assets to increase. Should we determine that increasing the securities portfolio or replacing the current securities maturities and principal payments is not an efficient use of capital, we may decrease the level of securities through proceeds from maturities, principal payments on MBS or sales. Our balance sheet strategy is designed such that our securities portfolio should help mitigate financial performance associated with potential business cycles that include slower loan growth and higher credit costs.

During the quarter ended June 30, 2017, we sold Texas municipal securities, U.S. Agency collateralized mortgage obligations (“CMO”), U.S. Agency commercial mortgage-backed securities (“CMBS”), and U.S. Treasury securities that resulted in an overall loss on the sale of AFS securities of \$75,000. During the second quarter, we sold selected long-term CMBS and lower yielding CMOs. In addition, we primarily sold Texas municipal securities that were potentially callable in the next three years. These security sales were designed to target one or both of the following objectives. First, we wanted to alleviate margin compression brought on by the Federal Reserve raising rates three times since December 2016, by selling lower yielding fixed rate securities. In addition, as long term interest rates continued to fall throughout the quarter, we sold longer duration securities. During the second quarter of 2017, we sold our remaining U.S. Treasury securities. These U.S. Treasury securities had longer durations and lower yields. During the quarter ended June 30, 2017, we primarily purchased premium CMOs, CMBS, and Texas municipal securities with favorable expected returns in relation to risk. Our total portfolio, comprised of investment and MBS, decreased from \$2.42 billion at December 31, 2016 to \$2.32 billion at June 30, 2017, which was partially offset by loan growth during the second quarter.

At June 30, 2017, securities decreased as a percentage of assets to 41.6% as compared to 43.4% at December 31, 2016 due to the overall increase in total assets of \$14.7 million and the \$93.7 million, or 3.9%, decrease in the securities portfolio. The size of the securities portfolio increased during the last quarter of 2016 to offset the interest expense associated with the subordinated debt we issued in September 2016. Our balance sheet management strategy is dynamic and will be continually reevaluated as market conditions warrant. As interest rates, yield curves, MBS prepayments, funding costs, security spreads and loan and deposit portfolios change, our determination of the proper types, amount and maturities of securities to own, as well as funding needs and funding sources, will continue to be reevaluated. Should the economics of purchasing securities decrease, we may allow this part of the balance sheet to shrink through run-off or security sales. However, should the economics become more attractive, we may strategically increase the securities portfolio and the balance sheet.

With respect to liabilities, we continue to utilize a combination of FHLB advances and deposits to achieve our strategy of minimizing cost while achieving overall interest rate risk objectives as well as the liability management objectives of the ALCO. FHLB funding is the primary wholesale funding source we are currently utilizing.

Our FHLB borrowings decreased 10.0%, or \$131.6 million, to \$1.18 billion at June 30, 2017 from \$1.31 billion at December 31, 2016. During the six months ended June 30, 2017, our long-term FHLB advances decreased \$280.9 million, to \$162.2 million from \$443.1 million at December 31, 2016. From time to time, the Company may enter into various variable rate advances with the FHLB. These advances totaled \$280.0 million at June 30, 2017 and \$250.0 million at December 31, 2016. These advances have interest rates ranging from one-month LIBOR plus 0.17% to one-month LIBOR plus 0.278%. Two of the variable rate advances have interest rates of three-month LIBOR minus 25 basis points. In connection with obtaining these advances, the Company entered into various interest rate swap contracts that are treated as cash flow hedges under ASC Topic 815, "Derivatives and Hedging" that effectively converted the variable rate advances to fixed interest rates ranging from 0.932% to 2.345% and original terms ranging from five years to ten years. The cash flows from the swaps are expected to be effective in hedging the variability in future cash flows attributable to fluctuations in the one-month and three-month LIBOR interest rates. During the first quarter of 2017, we terminated two interest rate swap contracts designated as cash flow hedges having a total notional value of \$40.0 million. At the time of termination, we determined that the underlying hedged forecasted transactions were still probable

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of occurring. These transactions are reevaluated on a monthly basis thereafter, to determine if the hedged forecasted transactions are still probable of occurring. If at a subsequent evaluation, it is determined that the transactions will not occur, any related gains or losses recorded in AOCI are immediately recognized in earnings.

On September 19, 2016, the Company issued \$100.0 million aggregate principal amount of fixed-to-floating rate subordinated notes that mature on September 30, 2026. This debt initially bears interest at a fixed rate of 5.50% through September 29, 2021 and thereafter, adjusts quarterly at a floating rate equal to three-month LIBOR plus 429.7 basis points. The proceeds from the sale of the subordinated notes were used for general corporate purposes, which included advances to the Bank to finance its activities. The unamortized discount and debt issuance costs reflected in the carrying amount of the subordinated notes totaled approximately \$1.8 million at June 30, 2017 and \$1.9 million at December 31, 2016.

Our brokered CDs increased from \$35.5 million at December 31, 2016 to \$133.5 million at June 30, 2017, or 275.9%, due to lower funding costs compared to other funding alternatives and ALCO objectives. At June 30, 2017, approximately \$127.7 million of our brokered CDs were non-callable with a weighted average cost of 78 basis points and remaining maturities of less than ten months. The remaining \$5.7 million have short-term calls that we control and mature within 2.5 years. Our wholesale funding policy currently allows maximum brokered CDs of \$180 million; however, this amount could be increased to match changes in ALCO objectives. The potential higher interest expense and lack of customer loyalty are risks associated with the use of brokered CDs.

During the six months ended June 30, 2017, the decrease in FHLB advances, partially offset by the increase in brokered deposits resulted in a decrease in our total wholesale funding as a percentage of deposits, not including brokered deposits, to 37.8% at June 30, 2017 from 38.5% at December 31, 2016.

Results of Operations

Our results of operations are dependent primarily on net interest income, which is the difference between the interest income earned on assets (loans and investments) and interest expense due on our funding sources (deposits and borrowings) during a particular period. Results of operations are also affected by our noninterest income, provision for loan losses, noninterest expenses and income tax expense. General economic and competitive conditions, particularly changes in interest rates, changes in interest rate yield curves, prepayment rates of MBS and loans, repricing of loan relationships, government policies and actions of regulatory authorities also significantly affect our results of operations. Future changes in applicable law, regulations or government policies may also have a material impact on us.

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RESULTS OF OPERATIONS

The “Average Balances with Average Yields and Rates” table that follows provides an analysis of net interest income for the three months ended June 30, 2017 and 2016 and details the components of the change in net interest income for the three months ended June 30, 2017 compared to the same period in the prior year (dollars in thousands).

| | Average Balances with Average Yields and Rates (unaudited) | | | | | |
|--|---|----------|-------------------|----------------|----------|-------------------|
| | Three Months Ended June 30, 2017 | | | June 30, 2016 | | |
| | Avg Balance | Interest | Avg Yield/Rate | Avg Balance | Interest | Avg Yield/Rate |
| ASSETS | | | | | | |
| Loans ^{(1) (2)} | \$2,557,093 | \$29,080 | 4.56 % | \$2,426,733 | \$27,275 | 4.52 % |
| Loans held for sale | 5,914 | 60 | 4.07 % | 4,984 | 40 | 3.23 % |
| Securities: | | | | | | |
| Investment securities (taxable) ⁽⁴⁾ | 58,168 | 267 | 1.84 % | 22,010 | 107 | 1.96 % |
| Investment securities (tax-exempt) ^{(3) (4)} | 749,259 | 9,386 | 5.02 % | 657,568 | 8,636 | 5.28 % |
| Mortgage-backed and related securities ⁽⁴⁾ | 1,594,269 | 10,818 | 2.72 % | 1,450,868 | 9,366 | 2.60 % |
| Total securities | 2,401,696 | 20,471 | 3.42 % | 2,130,446 | 18,109 | 3.42 % |
| FHLB stock, at cost, and other investments | 66,744 | 299 | 1.80 % | 52,952 | 185 | 1.41 % |
| Interest earning deposits | 156,124 | 364 | 0.94 % | 57,493 | 61 | 0.43 % |
| Federal funds sold | 5,326 | 14 | 1.05 % | — | — | — |
| Total earning assets | 5,192,897 | 50,288 | 3.88 % | 4,672,608 | 45,670 | 3.93 % |
| Cash and due from banks | 50,961 | | | 47,079 | | |
| Accrued interest and other assets | 358,041 | | | 377,983 | | |
| Less: Allowance for loan losses | (18,495) | | | (22,377) | | |
| Total assets | \$5,583,404 | | | \$5,075,293 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Savings deposits | \$262,009 | 121 | 0.19 % | \$244,639 | 68 | 0.11 % |
| Time deposits | 1,014,101 | 2,723 | 1.08 % | 976,600 | 1,927 | 0.79 % |
| Interest bearing demand deposits | 1,616,036 | 2,294 | 0.57 % | 1,727,431 | 1,520 | 0.35 % |
| Total interest bearing deposits | 2,892,146 | 5,138 | 0.71 % | 2,948,670 | 3,515 | 0.48 % |
| Short-term interest bearing liabilities | 1,010,484 | 2,480 | 0.98 % | 385,858 | 906 | 0.94 % |
| Long-term interest bearing liabilities – FHLB Dallas | 210,416 | 1,075 | 2.05 % | 492,296 | 1,874 | 1.53 % |
| Subordinated notes ⁽⁵⁾ | 98,151 | 1,398 | 5.71 % | — | — | — |
| Long-term debt ⁽⁶⁾ | 60,238 | 494 | 3.29 % | 60,233 | 416 | 2.78 % |
| Total interest bearing liabilities | 4,271,435 | 10,585 | 0.99 % | 3,887,057 | 6,711 | 0.69 % |
| Noninterest bearing deposits | 729,564 | | | 682,360 | | |
| Accrued expenses and other liabilities | 39,819 | | | 43,360 | | |
| Total liabilities | 5,040,818 | | | 4,612,777 | | |
| Shareholders' equity | 542,586 | | | 462,516 | | |
| Total liabilities and shareholders' equity | \$5,583,404 | | | \$5,075,293 | | |
| Net interest income ⁽⁷⁾ | | \$39,703 | | | \$38,959 | |
| Net interest margin on average earning assets ⁽⁷⁾ | | | 3.07 % | | | 3.35 % |
| Net interest spread ⁽⁷⁾ | | | 2.89 % | | | 3.24 % |

(1) Interest on loans includes net fees on loans that are not material in amount.

(2)

Interest income includes taxable-equivalent adjustments of \$1,050 and \$1,082 for the three months ended June 30, 2017 and 2016, respectively. See “Non-GAAP Financial Measures.”

(3) Interest income includes taxable-equivalent adjustments of \$3,229 and \$3,499 for the three months ended June 30, 2017 and 2016, respectively. See “Non-GAAP Financial Measures.”

(4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.

(5) The unamortized discount and debt issuance costs reflected in the carrying amount of the subordinated notes totaled approximately \$1.8 million for the three months ended June 30, 2017.

(6) Represents issuance of junior subordinated debentures. In connection with the adoption of ASU 2015-03 that requires unamortized debt issuance costs be presented as a direct deduction from the related debt liability, our average long-term debt for the three months ended June 30, 2017 and 2016 reflect unamortized debt issuance costs of \$73,000 and \$78,000, respectively.

(7) See “Non-GAAP Financial Measures.”

Note: As of June 30, 2017 and 2016, loans totaling \$3,034 and \$11,767, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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Net Interest Income

Net interest income is one of the principal sources of a financial institution's earnings stream and represents the difference or spread between interest and fee income generated from interest earning assets and the interest expense paid on deposits and borrowed funds. Fluctuations in interest rates or interest rate yield curves, as well as repricing characteristics and volume, and changes in the mix of interest earning assets and interest bearing liabilities, materially impact net interest income.

Quarterly Analysis of Changes in Interest Income and Interest Expense

The following table compares the dollar amount of increase (decrease) in interest income and interest expense resulting from changes in the volume of interest earning assets and interest bearing liabilities and from changes in average yields/rates for the periods shown (in thousands):

| | Three Months Ended June 30, 2017 Compared to 2016 | | | |
|--|--|-----------------------|------------------------|---|
| | Average Volume | Average Yield/Rate | Increase (Decrease) | |
| INTEREST INCOME: | | | | |
| Loans ⁽¹⁾ | \$ 1,479 | \$ 326 | \$ 1,805 | |
| Loans held for sale | 8 | 12 | 20 | |
| Investment securities (taxable) | 166 | (6 |) 160 | |
| Investment securities (tax-exempt) ⁽¹⁾ | 1,162 | (412 |) 750 | |
| Mortgage-backed securities | 957 | 495 | 1,452 | |
| FHLB stock, at cost and other investments | 55 | 59 | 114 | |
| Interest earning deposits | 179 | 124 | 303 | |
| Federal funds sold | 14 | — | 14 | |
| Total interest income | 4,020 | 598 | 4,618 | |
| INTEREST EXPENSE: | | | | |
| Savings deposits | 5 | 48 | 53 | |
| Time deposits | 77 | 719 | 796 | |
| Interest bearing demand deposits | (104 |) 878 | 774 | |
| Short-term interest bearing liabilities | 1,531 | 43 | 1,574 | |
| Long-term interest bearing liabilities – FHLB Dallas | (1,303 |) 504 | (799 |) |
| Subordinated notes | 1,398 | — | 1,398 | |
| Long-term debt | — | 78 | 78 | |
| Total interest expense | 1,604 | 2,270 | 3,874 | |
| Net interest income | \$ 2,416 | \$ (1,672 |) \$ 744 | |

(1) Interest yields on loans and securities that are nontaxable for federal income tax purposes are presented on a taxable equivalent basis. See “Non-GAAP Financial Measures.”

Note: Volume/Yield/Rate variances (change in volume times change in yield/rate) have been allocated to amounts attributable to changes in volumes and to changes in yields/rates in proportion to the amounts directly attributable to those changes.

Net interest income for the three months ended June 30, 2017 increased \$1.0 million, or 3.0%, to \$35.4 million, compared to \$34.4 million for the same period in 2016. The increase in net interest income for the three months ended June 30, 2017, compared to the same period in 2016, was due to the increase in interest income of \$4.9 million, or 12.0%, on loans and the securities portfolio, partially offset by the increase in interest expense of \$3.9 million on deposits and short- and long-term obligations. Our net interest margin decreased to 3.07% for the three months ended June 30, 2017, compared to 3.35% for the same period in 2016 and our net interest spread decreased to 2.89%, compared to 3.24% for the same period in 2016, due to higher average rates paid on interest-bearing liabilities along with a decrease in the average yield on earning assets.

Total interest income increased \$4.9 million, or 12.0%, to \$46.0 million during the three months ended June 30, 2017, compared to \$41.1 million during the same period in 2016. The increase was attributable to the increase in average earning assets of \$520.3 million, or 11.1%, to \$5.19 billion for the three months ended June 30, 2017 from \$4.67 billion for the same period in 2016, which was partially offset by the decrease in the average yield on earning assets to 3.88% for the three months ended June 30, 2017 from 3.93% for the three months ended June 30, 2016. The decrease in the average yield on earning assets during the three months ended June 30, 2017, was primarily the result of a decrease in purchase accounting accretion on loans and a decrease in the average yield on tax-exempt investment securities which decreased from 5.28% for the three months ended June 30, 2016 to 5.02% for the three months ended June 30, 2017.

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Total interest expense increased \$3.9 million, or 57.7%, to \$10.6 million during the three months ended June 30, 2017, compared to \$6.7 million during the same period in 2016. The increase in interest expense for the three months ended June 30, 2017 was attributable to the increase in average interest bearing liabilities of \$384.4 million, or 9.9%, from \$3.89 billion during the three months ended June 30, 2016 to \$4.27 billion during the three months ended June 30, 2017, and an increase in the average rate paid on interest bearing liabilities to 0.99% for the three months ended June 30, 2017, from 0.69% for the three months ended June 30, 2016. The increase in average interest-bearing liabilities was primarily the result of the increase in short-term interest bearing liabilities and the issuance of the subordinated notes, partially offset by a decrease in long-term interest bearing liabilities. The increase in average rates paid on interest bearing liabilities was a direct result of the subordinated debt issuance and the decrease in purchase accretion on the certificate of deposit premium during the third quarter of 2016 and overall higher interest rates.

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The “Average Balances with Average Yields and Rates” table that follows provides an analysis of net interest income for the six months ended June 30, 2017 and 2016 and details the components of the change in net interest income for the six months ended June 30, 2017 compared to the same period in the prior year (dollars in thousands).

| Average Balances with Average Yields and Rates (unaudited) | | | | | | | | |
|---|----------------|----------|-------------------|---------------|----------------|----------|-------------------|---|
| Six Months Ended | | | | | | | | |
| June 30, 2017 | | | | June 30, 2016 | | | | |
| | Avg Balance | Interest | Avg Yield/Rate | | Avg Balance | Interest | Avg Yield/Rate | |
| ASSETS | | | | | | | | |
| Loans ⁽¹⁾⁽²⁾ | \$2,553,183 | \$57,321 | 4.53 | % | \$2,430,783 | \$56,068 | 4.64 | % |
| Loans held for sale | 6,466 | 108 | 3.37 | % | 4,283 | 72 | 3.38 | % |
| Securities: | | | | | | | | |
| Investment securities (taxable) ⁽⁴⁾ | 72,262 | 644 | 1.80 | % | 31,835 | 321 | 2.03 | % |
| Investment securities (tax-exempt) ⁽³⁾⁽⁴⁾ | 764,431 | 19,315 | 5.10 | % | 646,667 | 17,130 | 5.33 | % |
| Mortgage-backed and related securities ⁽⁴⁾ | 1,582,455 | 20,863 | 2.66 | % | 1,452,605 | 18,757 | 2.60 | % |
| Total securities | 2,419,148 | 40,822 | 3.40 | % | 2,131,107 | 36,208 | 3.42 | % |
| FHLB stock, at cost, and other investments | 66,646 | 597 | 1.81 | % | 54,034 | 402 | 1.50 | % |
| Interest earning deposits | 159,162 | 710 | 0.90 | % | 54,255 | 131 | 0.49 | % |
| Federal funds sold | 6,266 | 28 | 0.90 | % | — | — | — | |
| Total earning assets | 5,210,871 | 99,586 | 3.85 | % | 4,674,462 | 92,881 | 4.00 | % |
| Cash and due from banks | 52,237 | | | | 51,406 | | | |
| Accrued interest and other assets | 354,283 | | | | 373,998 | | | |
| Less: Allowance for loan losses | (18,313) | | | | (21,233) | | | |
| Total assets | \$5,599,078 | | | | \$5,078,633 | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | | |
| Savings deposits | | | | | | | | |
| Savings deposits | \$257,402 | 213 | 0.17 | % | \$240,066 | 133 | 0.11 | % |
| Time deposits | 971,095 | 4,950 | 1.03 | % | 945,958 | 3,650 | 0.78 | % |
| Interest bearing demand deposits | 1,661,762 | 4,256 | 0.52 | % | 1,722,573 | 2,988 | 0.35 | % |
| Total interest bearing deposits | 2,890,259 | 9,419 | 0.66 | % | 2,908,597 | 6,771 | 0.47 | % |
| Short-term interest bearing liabilities | 1,009,023 | 4,545 | 0.91 | % | 399,922 | 1,602 | 0.81 | % |
| Long-term interest bearing liabilities – FHLB Dallas | 255,843 | 2,477 | 1.95 | % | 529,561 | 3,913 | 1.49 | % |
| Subordinated notes ⁽⁵⁾ | 98,134 | 2,791 | 5.74 | % | — | — | — | |
| Long-term debt ⁽⁶⁾ | 60,237 | 961 | 3.22 | % | 60,232 | 821 | 2.74 | % |
| Total interest bearing liabilities | 4,313,496 | 20,193 | 0.94 | % | 3,898,312 | 13,107 | 0.68 | % |
| Noninterest bearing deposits | 711,745 | | | | 677,612 | | | |
| Accrued expenses and other liabilities | 39,768 | | | | 44,247 | | | |
| Total liabilities | 5,065,009 | | | | 4,620,171 | | | |
| Shareholders' equity | 534,069 | | | | 458,462 | | | |
| Total liabilities and shareholders' equity | \$5,599,078 | | | | \$5,078,633 | | | |
| Net interest income ⁽⁷⁾ | | \$79,393 | | | | \$79,774 | | |
| Net interest margin on average earning assets ⁽⁷⁾ | | | 3.07 | % | | | 3.43 | % |
| Net interest spread ⁽⁷⁾ | | | 2.91 | % | | | 3.32 | % |

(1) Interest on loans includes net fees on loans that are not material in amount.

(2) Interest income includes taxable-equivalent adjustments of \$2,085 and \$2,142 for the six months ended June 30, 2017 and 2016, respectively. See “Non-GAAP Financial Measures.”

- (3) Interest income includes taxable-equivalent adjustments of \$6,604 and \$6,638 for the six months ended June 30, 2017 and 2016, respectively. See “Non-GAAP Financial Measures.”
- (4) For the purpose of calculating the average yield, the average balance of securities is presented at historical cost.
- (5) The unamortized discount and debt issuance costs reflected in the carrying amount of the subordinated notes totaled approximately \$1.9 million for the six months ended June 30, 2017.
Represents issuance of junior subordinated debentures. In connection with the adoption of ASU 2015-03 that requires unamortized debt issuance costs be presented as a direct deduction from the related debt liability, our average long-term debt for the three months ended June 30, 2017 and 2016 reflect unamortized debt issuance costs of \$74,000 and \$79,000 respectively.
- (6) See “Non-GAAP Financial Measures.”

Note: As of June 30, 2017 and 2016, loans totaling \$3,034 and \$11,767, respectively, were on nonaccrual status. Our policy is to reverse previously accrued but unpaid interest on nonaccrual loans; thereafter, interest income is recorded to the extent received when appropriate.

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Year-to-Date Analysis of Changes in Interest Income and Interest Expense

The following table compares the dollar amount of increase (decrease) in interest income and interest expense resulting from changes in the volume of interest earning assets and interest bearing liabilities and from changes in yields/rates for the periods shown (in thousands):

| | Six Months Ended June 30, 2017 Compared to 2016 | | |
|--|--|-----------------------|------------------------|
| | Average Volume | Average Yield/Rate | Increase (Decrease) |
| INTEREST INCOME: | | | |
| Loans ⁽¹⁾ | \$2,774 | \$ (1,521) | \$ 1,253 |
| Loans held for sale | 36 | — | 36 |
| Investment securities (taxable) | 364 | (41) | 323 |
| Investment securities (tax-exempt) ⁽¹⁾ | 3,005 | (820) | 2,185 |
| Mortgage-backed securities | 1,705 | 401 | 2,106 |
| FHLB stock, at cost and other investments | 104 | 91 | 195 |
| Interest earning deposits | 403 | 176 | 579 |
| Federal funds sold | 28 | — | 28 |
| Total interest income | 8,419 | (1,714) | 6,705 |
| INTEREST EXPENSE: | | | |
| Savings deposits | 10 | 70 | 80 |
| Time deposits | 99 | 1,201 | 1,300 |
| Interest bearing demand deposits | (109) | 1,377 | 1,268 |
| Short-term interest bearing liabilities | 2,721 | 222 | 2,943 |
| Long-term interest bearing liabilities – FHLB Dallas | (2,415) | 979 | (1,436) |
| Subordinated notes | 2,791 | — | 2,791 |
| Long-term debt | — | 140 | 140 |
| Total interest expense | 3,097 | 3,989 | 7,086 |
| Net interest income | \$5,322 | \$ (5,703) | \$ (381) |

(1) Interest yields on loans and securities that are nontaxable for federal income tax purposes are presented on a taxable equivalent basis. See “Non-GAAP Financial Measures.”

Note: Volume/Yield/Rate variances (change in volume times change in yield/rate) have been allocated to amounts attributable to changes in volumes and to changes in yields/rates in proportion to the amounts directly attributable to those changes.

Net interest income for the six months ended June 30, 2017 decreased \$290,000, or 0.4%, to \$70.7 million, compared to \$71.0 million for the same period in 2016. The decrease in net interest income for the six months ended June 30, 2017, compared to the same period in 2016, was due to the increase in interest expense of \$7.1 million, or 54.1%, on our deposits and short- and long-term obligations, which was partially offset by an increase in interest income of \$6.8 million, or 8.1%, on loans and the securities portfolio. Our net interest margin decreased to 3.07% for the six months ended June 30, 2017, compared to 3.43% for the same period in 2016 and our net interest spread decreased to 2.91%, compared to 3.32% for the same period in 2016, due to higher average rates paid on interest-bearing liabilities along with a decrease in the average yield on earning assets.

Total interest income increased \$6.8 million, or 8.1%, to \$90.9 million during the six months ended June 30, 2017, compared to \$84.1 million during the same period in 2016. The increase was attributable to the increase in average earning assets of \$536.4 million, or 11.5%, to \$5.21 billion for the six months ended June 30, 2017 from \$4.67 billion for the same period in 2016, which was partially offset by the decrease in the average yield on earning assets to 3.85% for the six months ended June 30, 2017 from 4.00% for the six months ended June 30, 2016. The decrease in the average yield on earning assets during the six months ended June 30, 2017 was the result of a decrease in the average

yield on investment securities of 23 basis points combined with a decrease in purchase accounting accretion on loans and the effect on the average yield on loans in 2016 of the \$1.3 million recovery of interest income on the payoff of a long-term nonaccrual loan during the first quarter of 2016.

Total interest expense increased \$7.1 million, or 54.1%, to \$20.2 million during the six months ended June 30, 2017, compared to \$13.1 million during the same period in 2016. The increase in interest expense for the six months ended June 30, 2017 was attributable to the increase in average interest bearing liabilities of \$415.2 million, or 10.7%, from \$3.90 billion during the six months ended June 30, 2016 to \$4.31 billion during the six months ended June 30, 2017, and an increase in the average rate paid on interest bearing liabilities to 0.94% for the six months ended June 30, 2017, from 0.68% for the six months ended June 30, 2016. The increase in average interest-bearing liabilities was primarily the result of the increase in short-term interest bearing

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liabilities and the issuance of the subordinated notes, partially offset by a decrease in long-term interest bearing liabilities. The increase in rates paid on interest bearing liabilities was a direct result of the subordinated debt issuance and the decrease in purchase accretion on the certificate of deposit premium during the third quarter of 2016 and overall higher interest rates.

Noninterest Income

Noninterest income consists of revenue generated from a broad range of financial services and activities and other fee generating programs that we either provide or in which we participate. The following table details the categories included in noninterest income (in thousands):

| | Three Months | | Six Months | |
|--|--------------|---------|------------|----------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Deposit services | \$5,255 | \$5,099 | \$10,369 | \$10,184 |
| Net (loss) gain on sale of securities available for sale | (75) | 728 | 247 | 3,169 |
| Gain on sale of loans | 505 | 873 | 1,206 | 1,516 |
| Trust income | 899 | 869 | 1,789 | 1,724 |
| Bank owned life insurance income | 635 | 647 | 1,269 | 1,321 |
| Brokerage services | 682 | 535 | 1,229 | 1,110 |
| Other noninterest income | 1,392 | 619 | 2,857 | 1,942 |
| Total noninterest income | \$9,293 | \$9,370 | \$18,966 | \$20,966 |

Noninterest income was \$9.3 million for the three months ended June 30, 2017 compared to \$9.4 million for the same period in 2016, a decrease of \$77,000, or 0.8%. The decrease for the three months ended June 30, 2017 when compared to the same period in 2016 was primarily due to a decrease in the net gain on sale of securities available for sale and a decrease in gain on sale of loans which was partially offset by increases in other noninterest income, deposit services income, and brokerage services income. We sold U.S. Agency CMOs, U.S. Agency CMBS, U.S. Agency MBS, Texas municipal securities and U.S. Treasury securities that resulted in a net loss on sale of AFS securities of \$75,000 for the three months ended June 30, 2017. The decrease in gain on sale of loans was primarily due to a slight decline in the volume of loans sold as well as less favorable pricing due to rising interest rates. The increase in other noninterest income was primarily attributable to an increase in income from customer derivatives and the return on other investments. The increase in deposit services income was primarily due to increases in overdraft charges, debit card income, and commercial demand deposit account service charges.

Noninterest income was \$19.0 million for the six months ended June 30, 2017 compared to \$21.0 million for the same period in 2016, a decrease of \$2.0 million, or 9.5%. The decrease for the six months ended June 30, 2017 when compared to the same period in 2016 was primarily due to a decrease in net gain on sale of securities available for sale and a decrease in gain on sale of loans which was partially offset by increases in other noninterest income, deposit services income, and brokerage services income. We sold U.S. Agency CMOs, U.S. Agency CMBS, U.S. Agency MBS, Texas municipal securities and U.S. Treasury securities that resulted in a net gain on sale of AFS securities of \$247,000 for the six months ended June 30, 2017. The decrease in gain on sale of loans was primarily due to a slight decline in the volume of loans sold as well as less favorable pricing due to rising interest rates. The increase in other noninterest income was primarily attributable to an increase in income from customer derivatives and mortgage servicing fee income, which were partially offset by a decrease in the return on other investments. The increase in deposit services income was primarily due to an increase in overdraft charges.

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Noninterest Expense

We incur certain types of noninterest expenses associated with the operation of our various business activities. The following table details the categories included in noninterest expense (in thousands):

| | Three Months | | Six Months | |
|--------------------------------------|--------------|-----------|------------|-----------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Salaries and employee benefits | \$ 14,915 | \$ 14,849 | \$ 30,834 | \$ 32,581 |
| Occupancy expense | 2,897 | 2,993 | 5,760 | 6,328 |
| Advertising, travel & entertainment | 548 | 722 | 1,131 | 1,407 |
| ATM and debit card expense | 889 | 736 | 1,816 | 1,448 |
| Professional fees | 1,050 | 1,478 | 1,989 | 2,816 |
| Software and data processing expense | 688 | 739 | 1,413 | 1,488 |
| Telephone and communications | 476 | 468 | 1,002 | 952 |
| FDIC insurance | 445 | 645 | 886 | 1,283 |
| FHLB prepayment fees | — | 148 | — | 148 |
| Other noninterest expense | 3,629 | 3,035 | 6,564 | 6,769 |
| Total noninterest expense | \$ 25,537 | \$ 25,813 | \$ 51,395 | \$ 55,220 |

Noninterest expense was \$25.5 million for the three months ended June 30, 2017 compared to \$25.8 million for the same period in 2016, representing a decrease of \$276,000, or 1.1%, for the three months ended June 30, 2017. The decrease for the three months ended June 30, 2017 was primarily the result of decreases in professional fees, FDIC insurance, advertising, travel and entertainment expense and FHLB prepayment fees, partially offset by increases in other noninterest expense.

Professional fees decreased for the three months ended June 30, 2017 compared to the same period in 2016 due to less expense in 2017 associated with the cost containment and process improvement efforts initiated in January 2016. FDIC insurance decreased for the three months ended June 30, 2017 compared to the same period in 2016 due to reduced FDIC assessment rates. Advertising, travel and entertainment expense decreased for the three months ended June 30, 2017 compared to the same period in 2016 primarily due to a decrease in advertising and travel expense. FHLB prepayment fees decreased \$148,000, or 100.0%, for the three months ended June 30, 2017, as compared to the same period in 2016 as a result of the prepayment of \$63.0 million in FHLB advances during the second quarter of 2016. The increase in other noninterest expense for the three months ended June 30, 2017 compared to the same period in 2016 was primarily due to \$473,000 in acquisition expense related to the pending merger with Diboll, as well as increases in provision expense for losses on unfunded loan commitments and check card losses.

Noninterest expense was \$51.4 million for the six months ended June 30, 2017 compared to \$55.2 million for the same period in 2016, representing a decrease of \$3.8 million, or 6.9%, for the six months ended June 30, 2017. The decrease for the six months ended June 30, 2017 was primarily the result of decreases in salary and employee benefits, professional fees, occupancy expense, FDIC insurance, advertising, travel and entertainment expense and other noninterest expense, partially offset by an increase in ATM and debit card expense.

Salary and employee benefits decreased for the six months ended June 30, 2017 compared to the same period in 2016 due to a decrease in retirement expense and to a lesser extent, direct salary expense, partially offset by an increase in health insurance expense. Retirement expense decreased \$2.1 million, or 60.4%, most of which was related to the acceptance of early retirement packages by 16 employees during the first quarter of 2016. Health insurance expense increased \$599,000, or 26.4%, during the six months ended June 30, 2017 compared to the same period last year. We have a self-insured health plan which is supplemented with stop loss insurance policies. Health insurance costs are rising nationwide and our health insurance costs may continue to increase during the remainder of 2017.

Professional fees decreased for the six months ended June 30, 2017 compared to the same period in 2016 due to less expense in 2017 associated with the cost containment and process improvement efforts initiated in January 2016. Occupancy expense decreased during the first half of 2017 due to lower rent expense as a result of early lease

terminations during 2016. FDIC insurance decreased for the six months ended June 30, 2017 compared to the same period in 2016 due to reduced FDIC assessment rates. Advertising, travel and entertainment expenses decreased for the six months ended June 30, 2017 compared to the same period in 2016 primarily due to a decrease in advertising and travel expense. FHLB prepayment fees decreased \$148,000, or 100.0%, for the six months ended June 30, 2017, as compared to the same period in 2016 as a result of the prepayment of \$63.0 million in FHLB advances during the second quarter of 2016.

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The decrease in other noninterest expense for the six months ended June 30, 2017 compared to the same period in 2016 was primarily due to decreases in the provision expense for losses on unfunded loan commitments, core deposit intangible amortization expense, losses on other real estate owned ("OREO") and equipment maintenance expense, partially offset by acquisition expense related to the pending merger with Diboll.

Income Taxes

During the first quarter of 2017, we adopted a new accounting standard that impacted how the income tax effects associated with stock-based compensation are recognized. See "Note 1 - Summary of Significant Accounting and Reporting Policies" for additional information.

Pre-tax income for the three and six months ended June 30, 2017 was \$17.8 million and \$35.8 million, respectively, compared to \$14.2 million and \$30.7 million for the same periods in 2016, respectively. We recorded income tax expense of \$3.4 million and \$6.4 million for the three and six months ended June 30, 2017, respectively, compared to income tax expense of \$2.8 million and \$5.7 million for the same periods in 2016, respectively. The effective tax rate ("ETR") as a percentage of pre-tax income was 18.8% and 17.8% for the three and six months ended June 30, 2017, respectively, compared to an ETR as a percentage of pre-tax income of 19.6% and 18.7% for the same periods in 2016, respectively. The lower ETR for the three and six months ended June 30, 2017 was mainly due to the adoption of the accounting standard referenced above, reducing income tax expense by \$84,000 and \$210,000 and the ETR by 0.5% and 0.6%, respectively. The ETR differs from the stated rate of 35% during the comparable period primarily due to the effect of tax-exempt income from municipal loans and securities, as well as bank owned life insurance.

Net deferred tax assets totaled \$22.4 million at June 30, 2017, as compared to \$28.9 million at December 31, 2016. The \$6.5 million decrease in deferred tax assets was due primarily to the decrease in the unrealized loss in the AFS securities portfolio. No valuation allowance for deferred tax assets was recorded at June 30, 2017 or December 31, 2016, as management believes it is more likely than not that all of the deferred tax assets will be realized in future years.

Liquidity and Interest Rate Sensitivity

Liquidity management involves our ability to convert assets to cash with a minimum risk of loss to enable us to meet our obligations to our customers at any time. This means addressing (1) the immediate cash withdrawal requirements of depositors and other fund providers; (2) the funding requirements of all lines and letters of credit; and (3) the short-term credit needs of customers. Liquidity is provided by short-term investments that can be readily liquidated with a minimum risk of loss. Cash, interest earning deposits and short-term investments with maturities or repricing characteristics of one year or less continue to be a substantial percentage of our total assets. At June 30, 2017, these investments were 7.5% of total assets, as compared with 7.2% for December 31, 2016 and 11.9% for June 30, 2016. The increase to 7.5% at June 30, 2017 is primarily reflective of increases in interest earning deposits. Liquidity is further provided through the matching, by time period, of rate sensitive interest earning assets with rate sensitive interest bearing liabilities. Southside Bank has three unsecured lines of credit for the purchase of overnight federal funds at prevailing rates with Frost Bank, TIB-The Independent Bankers Bank and Comerica Bank for \$30.0 million, \$15.0 million and \$7.5 million, respectively. There were no federal funds purchased at June 30, 2017. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit and at June 30, 2017, we had one outstanding letter of credit for \$195,000. At June 30, 2017, the amount of additional funding Southside Bank could obtain from FHLB, collateralized by FHLB stock, nonspecified loans and securities, was approximately \$683.0 million, net of FHLB stock purchases required. Southside Bank currently has no outstanding letters of credit from FHLB as collateral for a portion of its public fund deposits.

Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of new interest income through periods of changing interest rates. The ALCO closely monitors various liquidity ratios and interest rate spreads and margins. The ALCO performs interest rate simulation tests that apply various interest rate scenarios including immediate shocks and market value of portfolio equity ("MVPE") with interest rates immediately shocked plus and minus 200 basis points to assist in determining our overall interest rate risk and the adequacy of our liquidity position. In addition, the ALCO utilizes a simulation model to determine the impact on net interest income of several different interest rate scenarios. By utilizing this technology, we can determine changes

that need to be made to the asset and liability mix to minimize the change in net interest income under these various interest rate scenarios. See Part I - "Item 3. Quantitative and Qualitative Disclosures about Market Risk" in this Quarterly Report on Form 10-Q.

Capital Resources

Our total shareholders' equity at June 30, 2017 was \$547.1 million, representing an increase of 5.6%, or \$28.8 million, from December 31, 2016, and represented 9.8% of total assets at June 30, 2017 compared to 9.3% of total assets at December 31, 2016.

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Increases to our shareholders' equity consisted of net income of \$29.5 million, a decrease in accumulated other comprehensive loss of \$11.9 million, stock compensation expense of \$913,000, net issuance of common stock under employee stock plans of \$890,000, and common stock (21,474 shares) issued pursuant to our dividend reinvestment plan of \$721,000. These increases were partially offset by cash dividends paid of \$15.2 million.

As a result of regulations, which became applicable to the Company and the Bank on January 1, 2015, we are required to comply with higher minimum capital requirements (the "Updated Capital Rules"). The Updated Capital Rules made substantial changes to previous capital standards. Among other things, the regulations (i) introduced a new capital requirement known as "Common Equity Tier 1" ("CET1"), (ii) stated that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting certain requirements, (iii) defined CET1 to require that most deductions and adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) revised the scope of the deductions and adjustments from capital as compared to regulations that previously applied to the Company and other banking organizations.

The Updated Capital Rules also established the following minimum capital ratios, which started to phase in on January 1, 2015: 4.5 percent CET1 to risk-weighted assets; 6.0 percent Tier 1 capital to risk-weighted assets; 8.0 percent total capital to risk-weighted assets; and 4.0 percent Tier 1 leverage ratio to average consolidated assets. In addition, the Updated Capital Rules also introduced a minimum "capital conservation buffer" equal to 2.5% of an organization's total risk-weighted assets, which exists in addition to the required minimum CET1, Tier 1, and total capital ratios. The "capital conservation buffer," which must consist entirely of CET1, is designed to absorb losses during periods of economic stress. The Updated Capital Rules provide for a number of deductions from and adjustments to CET1, which include the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized through net operating loss carry-backs and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

Under the previous capital framework, the effects of accumulated other comprehensive income items included in shareholders' equity under U.S. GAAP were excluded for the purposes of determining capital ratios. Under the Updated Capital Rules, we elected to permanently exclude capital in accumulated other comprehensive income in Common Equity Tier 1 capital, Tier 1 capital, and Total capital to risk-weighted assets and Tier 1 capital to adjusted quarterly average assets.

Under the Updated Capital Rules, certain hybrid securities, such as trust preferred securities, do not qualify as Tier 1 capital. For bank holding companies that had assets of less than \$15 billion as of December 31, 2009, which includes Southside, trust preferred securities issued prior to May 19, 2010 can be treated as Tier 1 capital to the extent that they do not exceed 25% of Tier 1 capital after the application of capital deductions and adjustments.

Failure to meet minimum capital requirements under the Updated Capital Rules could result in certain mandatory and possibly additional discretionary actions by our regulators that, if undertaken, could have a direct material effect on our financial statements. Management believes that, as of June 30, 2017, we met all capital adequacy requirements to which we were subject.

The Federal Deposit Insurance Act requires bank regulatory agencies to take "prompt corrective action" with respect to FDIC-insured depository institutions that do not meet minimum capital requirements. A depository institution's treatment for purposes of the prompt corrective action provisions will depend on how its capital levels compare to various capital measures and certain other factors, as established by regulation. Prompt corrective action and other discretionary actions could have a direct material effect on our financial statements.

It is management's intention to maintain our capital at a level acceptable to all regulatory authorities and future dividend payments will be determined accordingly. Regulatory authorities require that any dividend payments made by either us or the Bank not exceed earnings for that year. Accordingly, shareholders should not anticipate a continuation of our cash dividend payments simply because of the existence of a dividend reinvestment program. The payment of dividends will depend upon future earnings, our financial condition, and other related factors including the discretion of our board of directors.

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To be categorized as well capitalized we must maintain minimum Common Equity Tier 1 risk-based, Tier 1 risk-based, Total capital risk-based and Tier 1 leverage ratios as set forth in the following table:

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Actions Provisions | |
|---|-----------|---------|-------------------------------|--------|---|---------|
| | Amount | Ratio | Amount | Ratio | Amount | Amount |
| June 30, 2017 (dollars in thousands) | | | | | | |
| Common Equity Tier 1 (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$476,647 | 14.91 % | \$143,878 | 4.50 % | N/A | N/A |
| Bank Only | \$601,390 | 18.81 % | \$143,849 | 4.50 % | \$207,782 | 6.50 % |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$533,412 | 16.68 % | \$191,837 | 6.00 % | N/A | N/A |
| Bank Only | \$601,390 | 18.81 % | \$191,799 | 6.00 % | \$255,732 | 8.00 % |
| Total Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$652,323 | 20.40 % | \$255,783 | 8.00 % | N/A | N/A |
| Bank Only | \$622,130 | 19.46 % | \$255,732 | 8.00 % | \$319,665 | 10.00 % |
| Tier 1 Capital (to Average Assets) ⁽¹⁾ | | | | | | |
| Consolidated | \$533,412 | 9.73 % | \$219,217 | 4.00 % | N/A | N/A |
| Bank Only | \$601,390 | 10.98 % | \$219,115 | 4.00 % | \$273,894 | 5.00 % |
| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Actions Provisions | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2016 (dollars in thousands) | | | | | | |
| Common Equity Tier 1 (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$461,158 | 14.64 % | \$141,759 | 4.50 % | N/A | N/A |
| Bank Only | \$566,423 | 17.98 % | \$141,734 | 4.50 % | \$204,726 | 6.50 % |
| Tier 1 Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$515,831 | 16.37 % | \$189,013 | 6.00 % | N/A | N/A |
| Bank Only | \$566,423 | 17.98 % | \$188,978 | 6.00 % | \$251,971 | 8.00 % |
| Total Capital (to Risk Weighted Assets) | | | | | | |
| Consolidated | \$633,289 | 20.10 % | \$252,017 | 8.00 % | N/A | N/A |
| Bank Only | \$585,781 | 18.60 % | \$251,971 | 8.00 % | \$314,964 | 10.00 % |
| Tier 1 Capital (to Average Assets) ⁽¹⁾ | | | | | | |
| Consolidated | \$515,831 | 9.46 % | \$218,029 | 4.00 % | N/A | N/A |
| Bank Only | \$566,423 | 10.40 % | \$217,892 | 4.00 % | \$272,365 | 5.00 % |

(1) Refers to quarterly average assets as calculated in accordance with policies established by bank regulatory agencies.

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Management believes that, as of June 30, 2017, Southside Bancshares and Southside Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

The table below summarizes our key equity ratios for the six months ended June 30, 2017 and 2016:

| | Three Months Ended June 30, 2017 | | 2016 | |
|--|---|---|-------|---|
| Return on Average Assets | 1.04 | % | 0.90 | % |
| Return on Average Shareholders' Equity | 10.70 | | 9.91 | |
| Dividend Payout Ratio – Basic | 57.14 | | 57.14 | |
| Dividend Payout Ratio – Diluted | 57.14 | | 57.14 | |
| Average Shareholders' Equity to Average Total Assets | 9.72 | | 9.11 | |
| | Six Months Ended June 30, 2017 | | 2016 | |
| Return on Average Assets | 1.06 | % | 0.99 | % |
| Return on Average Shareholders' Equity | 11.13 | | 10.93 | |
| Dividend Payout Ratio – Basic | 52.48 | | 51.09 | |
| Dividend Payout Ratio – Diluted | 53.00 | | 51.09 | |
| Average Shareholders' Equity to Average Total Assets | 9.54 | | 9.03 | |

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Composition of Loans

One of our main objectives is to seek attractive lending opportunities in Texas, primarily in the counties in which we operate. Refer to “Part I - Item 1. Business - Market Area” in our Annual Report on Form 10-K for the year ended December 31, 2016 for a discussion of our primary market area and the geographic concentration of our loan portfolio as of December 31, 2016. There were no substantial changes in these concentrations during the six months ended June 30, 2017. Substantially all of our loan originations are made to borrowers who live in and conduct business in the counties in Texas in which we operate or adjoin, with the exception of municipal loans, which are made almost entirely in Texas. Municipal loans are made to municipalities, counties, school districts and colleges primarily throughout the state of Texas.

Total loans increased \$53.7 million, or 2.1%, to \$2.61 billion at June 30, 2017 from \$2.56 billion at December 31, 2016, and increased \$225.9 million, or 9.5%, from \$2.38 billion at June 30, 2016. Average loans increased \$122.4 million, or 5.0%, for the six months ended June 30, 2017 when compared to the same period in 2016.

The banking industry is affected by general economic conditions such as interest rates, inflation, recession, unemployment and other factors beyond our control. During the last thirty years the Texas economy has continued to diversify, decreasing the overall impact of fluctuations in oil and gas prices; however, the oil and gas industry is still a significant component of the Texas economy. Since 2010, economic growth and business activity across a wide range of industries and regions in the U.S. has been slow and uneven. During a majority of that time economic growth and business activity in Texas exceeded the U.S. average. However in 2014, decisions by certain members of the Organization of Petroleum Exporting Countries (“OPEC”) to maintain higher crude oil production levels, combined with increased production levels in the United States, led to increased global oil supplies which has resulted in significant declines in market oil prices. Decreased market oil prices have compressed margins for many U.S. and Texas-based oil producers, particularly those that utilize higher-cost production technologies such as hydraulic fracking and horizontal drilling, as well as oilfield service providers, energy equipment manufacturers and transportation suppliers, among others. As of July 20, 2017, the price per barrel of crude oil was approximately \$47 compared to approximately \$98 as of December 31, 2013. A prolonged period of low oil prices could have a negative impact on the U.S. economy and, in particular, the economies of energy-dominant states such as Texas. Energy loans comprised approximately 1.14% and 1.09% of our loan portfolio at June 30, 2017 and December 31, 2016, respectively. We cannot predict whether current economic conditions will improve, remain the same or decline. A decline in credit markets generally could adversely affect our financial condition and results of operation if we are unable to extend credit or sell loans into the secondary market.

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The following table sets forth loan totals by class for the periods presented:

| | At June 30, 2017 | At December 31, 2016 | At June 30, 2016 |
|------------------------|------------------------|-------------------------------|------------------------|
| | (in thousands) | | |
| Real Estate Loans: | | | |
| Construction | \$386,853 | \$380,175 | \$425,595 |
| 1-4 Family Residential | 615,405 | 637,239 | 633,400 |
| Commercial | 1,033,629 | 945,978 | 694,272 |
| Commercial Loans | 172,311 | 177,265 | 197,896 |
| Municipal Loans | 305,023 | 298,583 | 292,909 |
| Loans to Individuals | 96,977 | 117,297 | 140,249 |
| Total Loans | \$2,610,198 | \$2,556,537 | \$2,384,321 |

Construction loans increased \$6.7 million, or 1.8%, to \$386.9 million at June 30, 2017 from \$380.2 million at December 31, 2016, and decreased \$38.7 million, or 9.1%, from \$425.6 million at June 30, 2016. Our construction loans increased during the six months ended June 30, 2017 due to continued growth in our Austin and Dallas-Fort Worth markets. The decrease compared to June 30, 2016 was due to payoffs and transfers to permanent financing, more than offsetting new loans and advances on existing construction projects during that time.

1-4 family residential loans decreased \$21.8 million, or 3.4%, to \$615.4 million at June 30, 2017 from \$637.2 million at December 31, 2016, and decreased \$18.0 million, or 2.8%, from \$633.4 million at June 30, 2016 due primarily to payoffs in excess of originations.

Commercial real estate loans increased \$87.7 million, or 9.3%, to \$1.03 billion at June 30, 2017 from \$946.0 million at December 31, 2016, and increased \$339.4 million, or 48.9%, from \$694.3 million at June 30, 2016. Our commercial real estate loans continued to increase during the six months ended June 30, 2017 primarily as a result of providing permanent financing on completed construction projects and continued growth in our Austin and Dallas-Fort Worth markets.

Commercial loans decreased \$5.0 million, or 2.8%, to \$172.3 million at June 30, 2017 from \$177.3 million at December 31, 2016, and decreased \$25.6 million, or 12.9%, from \$197.9 million at June 30, 2016 due primarily to payoffs in excess of originations.

Municipal loans increased \$6.4 million, or 2.2%, to \$305.0 million at June 30, 2017 from \$298.6 million at December 31, 2016, and increased \$12.1 million, or 4.1%, from \$292.9 million at June 30, 2016.

Loans to individuals decreased \$20.3 million, or 17.3%, to \$97.0 million at June 30, 2017, from \$117.3 million at December 31, 2016, and decreased \$43.3 million, or 30.9%, from \$140.2 million at June 30, 2016, which primarily reflects the continued roll-off of the indirect automobile loan portfolio acquired from Omni.

Loan Loss Experience and Allowance for Loan Losses

The allowance for loan losses is based on the most current review of the loan portfolio and is a result of multiple processes. First, we utilize historical net charge-off data to establish general reserve amounts for each class of loans. The historical charge-off figure is further adjusted through qualitative factors that include general trends in past dues, nonaccruals and classified loans to more effectively and promptly react to both positive and negative movements not reflected in historical data. Second, our lenders have the primary responsibility for identifying problem loans based on customer financial stress and underlying collateral. These recommendations are reviewed by senior loan administration, the special assets department and the loan review department on a monthly basis. Third, the loan review department independently reviews the portfolio on an annual basis. The loan review department follows a board-approved annual loan review scope. The loan review scope encompasses a number of considerations including the size of the loan, the type of credit extended, the seasoning of the loan and the performance of the loan. The loan review scope, as it relates to size, focuses more on larger dollar loan relationships, typically aggregate debt of \$500,000 or greater. The loan review officer also reviews specific reserves compared to general reserves to determine

trends in comparative reserves as well as losses not reserved for prior to charge-off to determine the effectiveness of the specific reserve process.

At each review, a subjective analysis methodology is used to grade the respective loan. Categories of grading vary in severity from loans that do not appear to have a significant probability of loss at the time of review to loans that indicate a probability that the entire balance of the loan will be uncollectible. If at the time of review we determine it is probable that we will not collect

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the principal and interest cash flows contractually due on the loan, estimates of future expected cash flows or appraisals of the collateral securing the debt are used to determine the necessary allowances. The internal loan review department maintains a list (“Watch List”) of all loans or loan relationships that are graded as having more than the normal degree of risk associated with them. In addition, a list of specifically reserved loans or loan relationships of \$150,000 or more is updated on a quarterly basis in order to properly determine necessary allowances and keep management informed on the status of attempts to correct the deficiencies noted with respect to the loan.

We calculate historical loss ratios for pools of loans with similar characteristics based on the proportion of actual charge-offs experienced, consistent with the characteristics of remaining loans, to the total population of loans in the pool. The historical gross loss ratios are updated based on actual charge-off experience quarterly and adjusted for qualitative factors. All loans are subject to individual analysis if determined to be impaired with the exception of consumer loans and loans secured by 1-4 family residential loans.

Industry and our own experience indicates that a portion of our loans will become delinquent and a portion of the loans will require partial or full charge-off. Regardless of the underwriting criteria utilized, losses may occur as a result of various factors beyond our control, including, among other things, changes in market conditions affecting the value of properties used as collateral for loans and problems affecting the credit worthiness of the borrower and the ability of the borrower to make payments on the loan. Our determination of the appropriateness of the allowance for loan losses is based on various considerations, including an analysis of the risk characteristics of various classifications of loans, previous loan loss experience, specific loans which have loan loss potential, delinquency trends, estimated fair value of the underlying collateral, current economic conditions, and geographic and industry loan concentration.

After all of the data in the loan portfolio is accumulated, the reserve allocations are separated into various loan classes. As of June 30, 2017, our review of the loan portfolio indicated that a loan loss allowance of \$19.2 million was appropriate to cover probable losses in the portfolio. Changes in economic and other conditions may require future adjustments to the allowance for loan losses.

During the six months ended June 30, 2017, the allowance for loan losses increased \$1.3 million, or 7.4%, to \$19.2 million, or 0.74% of total loans, when compared to \$17.9 million, or 0.70% of total loans at December 31, 2016, and increased \$4.3 million, or 29.1%, from \$14.9 million, or 0.63% of total loans at June 30, 2016, due primarily to loan growth and changes in qualitative factors in accordance with our methodology for determining the estimate of the allowance for loan loss.

For the three and six months ended June 30, 2017, loan charge-offs were \$1.1 million and \$2.1 million, respectively, and recoveries were \$498,000 and \$1.0 million, respectively. For the three and six months ended June 30, 2016, loan charge-offs were \$11.3 million and \$12.4 million, respectively, and recoveries were \$645,000 and \$1.5 million, respectively. The necessary provision expense was estimated at \$1.3 million and \$2.4 million for the three and six months ended June 30, 2017, respectively, a decrease of \$2.4 million, or 64.3%, and \$3.6 million, or 59.8%, from \$3.8 million and \$6.1 million for the comparable periods in 2016. The significant decrease in provision expense was due to the partial charge-offs applied to two large commercial borrowing relationships during the second quarter of 2016.

Nonperforming Assets

Nonperforming assets consist of delinquent loans 90 days or more past due, nonaccrual loans, OREO, repossessed assets and restructured loans. Nonaccrual loans are loans 90 days or more delinquent and collection in full of both the principal and interest is not expected. Additionally, some loans that are not delinquent may be placed on nonaccrual status due to doubts about full collection of principal or interest. When a loan is categorized as nonaccrual, the accrual of interest is discontinued and any accrued balance is reversed for financial statement purposes. OREO represents real estate taken in full or partial satisfaction of debts previously contracted. The dollar amount of OREO is based on a current evaluation of the OREO at the time it is recorded on our books, net of estimated selling costs. Updated valuations are obtained as needed and any additional impairments are recognized. Restructured loans represent loans that have been renegotiated to provide a below market or deferral of interest or principal because of deterioration in the financial position of the borrowers. The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a

concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Categorization of a loan as nonperforming is not in itself a reliable indicator of potential loan loss. Other factors, such as the value of collateral securing the loan and the financial condition of the borrower must be considered in judgments as to potential loan loss.

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The following tables set forth nonperforming assets for the periods presented (in thousands):

| | At June 30, 2017 | At December 31, 2016 | At June 30, 2016 |
|---|---------------------------|-------------------------------|------------------------|
| Nonaccrual loans | \$3,034 | \$ 8,280 | \$11,767 |
| Accruing loans past due more than 90 days | — | 6 | 6 |
| Restructured loans | 5,884 | 6,431 | 12,477 |
| Other real estate owned | 233 | 339 | 237 |
| Repossessed assets | 14 | 49 | 23 |
| Total Nonperforming Assets | \$9,165 | \$ 15,105 | \$24,510 |

| | At June 30, 2017 | At December 31, 2016 | At June 30, 2016 |
|---|------------------------|-------------------------------|------------------------|
| Asset Quality Ratios: | | | |
| Nonaccruing loans to total loans | 0.12 | % 0.32 | % 0.49 |
| Allowance for loan losses to nonaccruing loans | 634.18 | 216.32 | 126.69 |
| Allowance for loan losses to nonperforming assets | 209.94 | 118.58 | 60.82 |
| Allowance for loan losses to total loans | 0.74 | 0.70 | 0.63 |
| Nonperforming assets to total assets | 0.16 | 0.27 | 0.49 |
| Net charge-offs to average loans | 0.09 | 0.47 | 0.90 |

Asset Quality Ratios:

| | | | |
|---|--------|--------|--------|
| Nonaccruing loans to total loans | 0.12 | % 0.32 | % 0.49 |
| Allowance for loan losses to nonaccruing loans | 634.18 | 216.32 | 126.69 |
| Allowance for loan losses to nonperforming assets | 209.94 | 118.58 | 60.82 |
| Allowance for loan losses to total loans | 0.74 | 0.70 | 0.63 |
| Nonperforming assets to total assets | 0.16 | 0.27 | 0.49 |
| Net charge-offs to average loans | 0.09 | 0.47 | 0.90 |

Total nonperforming assets at June 30, 2017 were \$9.2 million, a decrease of \$5.9 million, or 39.3%, from \$15.1 million at December 31, 2016 and a decrease of \$15.3 million, or 62.6%, from \$24.5 million at June 30, 2016.

From December 31, 2016 to June 30, 2017, nonaccrual loans decreased \$5.2 million, or 63.4%, to \$3.0 million, and decreased \$8.7 million, or 74.2%, from June 30, 2016. Of the total nonaccrual loans at June 30, 2017, \$1.0 million are 1-4 family residential real estate loans, \$706,000 are commercial real estate loans, \$663,000 are commercial loans, \$600,000 are loans to individuals, and \$53,000 are construction loans. Restructured loans totaled \$5.9 million at June 30, 2017, a decrease of \$547,000, or 8.5%, compared to December 31, 2016 and decreased \$6.6 million, or 52.8%, when compared to \$12.5 million at June 30, 2016. OREO decreased \$106,000, or 31.3%, to \$233,000 at June 30, 2017 from \$339,000 at December 31, 2016 and decreased \$4,000, or 1.7%, from \$237,000 at June 30, 2016. The OREO at June 30, 2017 consisted primarily of construction and 1-4 family residential properties. We are actively marketing all properties and none are being held for investment purposes. Repossessed assets decreased \$35,000, or 71.4%, to \$14,000 at June 30, 2017, from \$49,000 at December 31, 2016 and decreased \$9,000, or 39.1%, from \$23,000 at June 30, 2016.

Pending Acquisition

See “Note 2 - Pending Acquisition” in our consolidated financial statements included in this Quarterly Report on Form 10-Q.

Recent Accounting Pronouncements

See “Note 1 – Summary of Significant Accounting and Reporting Policies” in our consolidated financial statements included in this Quarterly Report on Form 10-Q.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The disclosures set forth in this item are qualified by the section captioned “Forward-Looking Statements” included in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this report and other cautionary statements set forth elsewhere in this Quarterly Report on Form 10-Q.

Refer to the discussion of market risks included in “Item 7A. Quantitative and Qualitative Disclosures About Market Risks” in our Annual Report on Form 10-K for the year ended December 31, 2016. There have been no significant changes in the types of market risks we face since December 31, 2016.

In the banking industry, a major risk exposure is changing interest rates. The primary objective of monitoring our interest rate sensitivity, or risk, is to provide management the tools necessary to manage the balance sheet to minimize adverse changes in net interest income as a result of changes in the direction and level of interest rates. Federal Reserve Board monetary control efforts, the effects of deregulation, economic uncertainty and legislative changes have been significant factors affecting the task of managing interest rate sensitivity positions in recent years.

In an attempt to manage our exposure to changes in interest rates, management closely monitors our exposure to interest rate risk through our ALCO. Our ALCO meets regularly and reviews our interest rate risk position and makes recommendations to our board for adjusting this position. In addition, our board reviews our asset/liability position on a monthly basis. We primarily use two methods for measuring and analyzing interest rate risk: net income simulation analysis and MVPE modeling. We utilize the net income simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. This model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model is used to measure the impact on net interest income relative to a base case scenario of rates immediately increasing 100 and 200 basis points or decreasing 100 and 200 basis points over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet. The impact of interest rate-related risks such as prepayment, basis and option risk are also considered. As of June 30, 2017, the model simulations projected that immediate increases in interest rates of 100 and 200 basis points would result in positive variances in net interest income of 2.55% and 3.08%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in positive variances in net interest income of 6.63% and 5.42%, respectively, relative to the base case over the next 12 months. As of December 31, 2016, the model simulations projected that an immediate increase in interest rates of 100 basis points would result in a positive variance on net interest income of 0.88% and an immediate increase in interest rates of 200 basis points would result in a negative variance on net interest income of 0.21%, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in positive variances in net interest income of 2.25% and 1.67%, respectively, relative to the base case over the next 12 months. As of June 30, 2016, the model simulations projected that 100 and 200 basis point immediate increases in interest rates would result in positive variances on net interest income of 1.61% and 3.37%, respectively, relative to the base case over the next 12 months, while an immediate decrease in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 1.41% and 1.14%, respectively, relative to the base case over the next 12 months. As part of the overall assumptions, certain assets and liabilities are given reasonable floors. This type of simulation analysis requires numerous assumptions including but not limited to changes in balance sheet mix, prepayment rates on mortgage-related assets and fixed rate loans, cash flows and repricing of all financial instruments, changes in volumes and pricing, future shapes of the yield curve, relationship of market interest rates to each other (basis risk), credit spread and deposit sensitivity. Assumptions are based on management’s best estimates but may not accurately reflect actual results under certain changes in interest rates.

The ALCO monitors various liquidity ratios to ensure a satisfactory liquidity position for us. Management continually evaluates the condition of the economy, the pattern of market interest rates and other economic data to determine the types of investments that should be made and at what maturities. Using this analysis, management from time to time assumes calculated interest sensitivity gap positions to maximize net interest income based upon anticipated

movements in the general level of interest rates. Regulatory authorities also monitor our gap position along with other liquidity ratios. In addition, as described above, we utilize a simulation model to determine the impact of net interest income under several different interest rate scenarios. By utilizing this technology, we can determine changes that need to be made to the asset and liability mixes to mitigate the change in net interest income under these various interest rate scenarios.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer (“CEO”) and our Chief Financial Officer (“CFO”), undertook an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report, and, based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report, in recording, processing, summarizing and reporting in a timely manner the information that the Company is required to disclose in its reports under the Exchange Act and in accumulating and communicating to the Company’s management, including the Company’s CEO and CFO, such information as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

No changes were made to our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended June 30, 2017 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are a party to various litigation in the normal course of business. Management, after consulting with our legal counsel, believes that any liability resulting from litigation will not have a material effect on our financial position, results of operations or liquidity.

ITEM 1A. RISK FACTORS

Additional information regarding risk factors appears in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Forward-Looking Statements” of this Form 10-Q and in Part I - “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2016. The risks and uncertainties described in our Annual Report on Form 10-K for the year ended December 31, 2016 are not the only ones we face. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

A list of exhibits to this Form 10-Q is set forth on the Exhibit Index and is incorporated herein by reference.

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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.

SOUTHSIDE BANCSHARES, INC.

DATE: July 28, 2017 BY: /s/ Lee R. Gibson
Lee R. Gibson, CPA
President and Chief Executive Officer
(Principal Executive Officer)

DATE: July 28, 2017 BY: /s/ Julie N. Shamburger
Julie N. Shamburger, CPA
Senior Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

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Exhibit Index

| Exhibit Number | Exhibit Description | Filed Herewith | Incorporated by Reference | | |
|----------------|---|----------------|---------------------------|----------------|----------|
| | | | Exhibit Form | Filing Date | File No. |
| (2) | Plan of Acquisition, reorganization, arrangement, liquidation or succession <u>Agreement and Plan of Merger, dated June 12, 2017, by and among Southside Bancshares, Inc., Rocket Merger Sub, Inc. and Diboll State Bancshares, Inc.</u> | X | | | |
| (3) | Articles of Incorporation and Bylaws <u>Restated Certificate of Formation of Southside Bancshares, Inc.</u> | | 3 (a) | 10-Q 5/9/2014 | 0-12247 |
| 3.1 | <u>Amended and Restated Bylaws of Southside Bancshares, Inc.</u> | | 3.1 | 8-K 11/24/2014 | 0-12247 |
| (10) | Material Contracts <u>Southside Bancshares, Inc. 2017 Incentive Plan</u> | | 10.1 | 8-K 05/12/2017 | 0-12247 |
| (31) | Rule 13a-14(a)/15d-14(a) Certifications <u>Certification of Chief Executive Officer</u> | X | | | |
| 31.1 | <u>Certification of Chief Executive Officer</u> | X | | | |
| (32) | Section 1350 Certification <u>Certification of Executive Officer and Chief Financial Officer</u> | X | | | |
| †32 | | | | | |
| (101) | Interactive Data File XBRL Instance Document. | X | | | |
| 101.INS | | | | | |
| 101.SCH | XBRL Taxonomy Extension Schema Document. | X | | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. | X | | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document. | X | | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. | X | | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. | X | | | |

† The certification attached as Exhibit 32 accompanies this Quarterly Report on Form 10-Q and is “furnished” to the Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed “filed” by us for

purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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