

SOUTHSIDE BANCSHARES INC

Form 10-Q

April 30, 2019

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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 March 31, 2019

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 every Interactive Data File required to be submitted 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 such files). Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the

extended transition period for complying with any new  
or revised financial accounting standards provided  
pursuant to Section 13(a) of the Exchange Act.

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

The number of shares of the issuer's common stock, par value \$1.25, outstanding as of April 24, 2019 was 33,718,079  
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)

|  | March 31,<br>2019 | December 31,<br>2018 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Cash and due from banks  | \$81,981          | \$ 87,375            |
| Interest earning deposits  | 184,612           | 23,884               |
| Federal funds sold   | 3,350             | 9,460                |
| Total cash and cash equivalents  | 269,943           | 120,719              |
| Securities:  |                   |                      |
| Securities available for sale, at estimated fair value   | 1,876,255         | 1,989,436            |
| Securities held to maturity, at carrying value (estimated fair value of \$147,666 and \$159,781, respectively) | 147,431           | 162,931              |
| FHLB stock, at cost  | 35,269            | 32,583               |
| Equity investments   | 12,182            | 12,093               |
| Loans held for sale  | 384               | 601                  |
| Loans:   |                   |                      |
| Loans  | 3,305,110         | 3,312,799            |
| Less: Allowance for loan losses  | (24,155 )         | (27,019 )            |
| Net loans  | 3,280,955         | 3,285,780            |
| Premises and equipment, net  | 138,290           | 135,972              |
| Operating lease right-of-use assets  | 9,455             | —                    |
| Goodwill   | 201,116           | 201,116              |
| Other intangible assets, net   | 16,600            | 17,779               |
| Interest receivable  | 20,017            | 27,287               |
| Deferred tax asset, net  | 491               | 9,776                |
| Unsettled trades to sell securities  | 95,482            | —                    |
| Unsettled issuances of brokered certificates of deposit  | —                 | 15,236               |
| Bank owned life insurance  | 98,704            | 98,160               |
| Other assets   | 14,622            | 14,025               |
| Total assets   | \$6,217,196       | \$ 6,123,494         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                   |                      |
| Deposits:  |                   |                      |
| Noninterest bearing  | \$1,038,116       | \$ 994,680           |
| Interest bearing   | 3,529,777         | 3,430,350            |
| Total deposits   | 4,567,893         | 4,425,030            |
| Federal funds purchased and repurchase agreements  | 8,637             | 36,810               |
| FHLB borrowings  | 619,861           | 719,065              |
| Subordinated notes, net of unamortized debt issuance costs   | 98,448            | 98,407               |
| Trust preferred subordinated debentures, net of unamortized debt issuance costs                                | 60,247            | 60,246               |
| Unsettled trades to purchase securities  | 55,826            | 6,378                |
| Operating lease liabilities  | 9,811             | —                    |
| Other liabilities  | 38,440            | 46,267               |

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|  |             |              |
|--|-------------|--------------|
| Total liabilities  | 5,459,163   | 5,392,203    |
| Off-balance-sheet arrangements, commitments and contingencies (Note 14)  |             |              |
| Shareholders' equity:  |             |              |
| Common stock: (\$1.25 par value, 80,000,000 shares authorized, 37,855,789 shares issued at March 31, 2019 and 37,845,224 shares issued at December 31, 2018) | 47,320      | 47,307       |
| Paid-in capital  | 763,582     | 762,470      |
| Retained earnings  | 57,023      | 64,797       |
| Treasury stock: (shares at cost, 4,137,710 at March 31, 2019 and 4,120,475 at December 31, 2018)   | (94,119 )   | (93,055 )    |
| Accumulated other comprehensive loss   | (15,773 )   | (50,228 )    |
| Total shareholders' equity   | 758,033     | 731,291      |
| Total liabilities and shareholders' equity   | \$6,217,196 | \$ 6,123,494 |
| 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<br>Ended<br>March 31, |          |
|--|------------------------------------|----------|
|  | 2019                               | 2018     |
| Interest income:   |                                    |          |
| Loans  | \$41,619                           | \$38,830 |
| Investment securities – taxable                          | 28                                 | 227      |
| Investment securities – tax-exempt                       | 4,118                              | 6,381    |
| Mortgage-backed securities                               | 12,474                             | 10,894   |
| FHLB stock and equity investments                        | 355                                | 414      |
| Other interest earning assets                            | 433                                | 448      |
| Total interest income                                    | 59,027                             | 57,194   |
| Interest expense:  |                                    |          |
| Deposits   | 11,241                             | 7,451    |
| FHLB borrowings  | 4,457                              | 3,632    |
| Subordinated notes                                       | 1,400                              | 1,398    |
| Trust preferred subordinated debentures                  | 729                                | 569      |
| Other borrowings   | 75                                 | 11       |
| Total interest expense                                   | 17,902                             | 13,061   |
| Net interest income                                      | 41,125                             | 44,133   |
| Provision for loan losses                                | (918 )                             | 3,735    |
| Net interest income after provision for loan losses      | 42,043                             | 40,398   |
| Noninterest income:                                      |                                    |          |
| Deposit services   | 5,986                              | 6,179    |
| Net gain (loss) on sale of securities available for sale | 256                                | (827 )   |
| Gain on sale of loans                                    | 93                                 | 115      |
| Trust income   | 1,541                              | 1,760    |
| Bank owned life insurance income                         | 544                                | 632      |
| Brokerage services                                       | 517                                | 450      |
| Other  | 601                                | 1,301    |
| Total noninterest income                                 | 9,538                              | 9,610    |
| Noninterest expense:                                     |                                    |          |
| Salaries and employee benefits                           | 18,046                             | 18,559   |
| Net occupancy expense                                    | 3,175                              | 3,583    |
| Acquisition expense                                      | —                                  | 832      |
| Advertising, travel & entertainment                      | 847                                | 685      |
| ATM expense  | 180                                | 346      |
| Professional fees  | 1,314                              | 1,070    |
| Software and data processing expense                     | 1,076                              | 1,023    |
| Telephone and communications                             | 487                                | 538      |
| FDIC insurance   | 422                                | 497      |
| Amortization expense on intangibles                      | 1,179                              | 1,378    |
| Other  | 2,901                              | 3,156    |
| Total noninterest expense                                | 29,627                             | 31,667   |

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|                                  |          |          |
|----------------------------------|----------|----------|
| Income before income tax expense | 21,954   | 18,341   |
| Income tax expense               | 3,137    | 2,090    |
| Net income                       | \$18,817 | \$16,251 |

|                                      |        |        |
|--------------------------------------|--------|--------|
| Earnings per common share – basic    | \$0.56 | \$0.46 |
| Earnings per common share – diluted  | \$0.56 | \$0.46 |
| Cash dividends paid per common share | \$0.30 | \$0.28 |

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<br>Ended<br>March 31, |           |
|---|------------------------------------|-----------|
|   | 2019                               | 2018      |
| Net income  | \$18,817                           | \$16,251  |
| Other comprehensive income (loss):  |                                    |           |
| Securities available for sale and transferred securities:   |                                    |           |
| Change in unrealized holding gain (loss) on available for sale securities during the period   | 46,626                             | (37,783 ) |
| Unrealized net gain on securities transferred from held to maturity to available for sale under the transition guidance enumerated in ASU 2017-12 | —                                  | 11,881    |
| Change in net unrealized loss on securities transferred from held to maturity to available for sale   | —                                  | 401       |
| Reclassification adjustment for amortization related to available for sale and held to maturity debt securities                                   | 491                                | 138       |
| Reclassification adjustment for net (gain) loss on sale of available for sale securities, included in net income                                  | (256 )                             | 827       |
| Derivatives:  |                                    |           |
| Change in net unrealized (loss) gain on effective cash flow hedge interest rate swap derivatives  | (3,120 )                           | 4,245     |
| Reclassification adjustment of net gain related to derivatives designated as cash flow hedge  | (668 )                             | (127 )    |
| Pension plans:  |                                    |           |
| Amortization of net actuarial loss and prior service credit, included in net periodic benefit cost  | 541                                | 473       |
| Other comprehensive income (loss), before tax   | 43,614                             | (19,945 ) |
| Income tax (expense) benefit related to items of other comprehensive income (loss)  | (9,159 )                           | 4,188     |
| Other comprehensive income (loss), net of tax   | 34,455                             | (15,757 ) |
| Comprehensive income  | \$53,272                           | \$494     |

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<br>Stock | Paid In<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|--|-----------------|--------------------|----------------------|-------------------|--|----------------------------------|
| Balance at December 31, 2017   | \$ 47,253       | \$ 757,439         | \$ 32,851            | \$ (47,105)       | \$ (36,298 )   | \$ 754,140                       |
| Cumulative effect of accounting change                                     | —               | —                  | (85 )                | —                 | 85   | —                                |
| Adjusted beginning balance   | 47,253          | 757,439            | 32,766               | (47,105 )         | (36,213 )  | 754,140                          |
| Net income   | —               | —                  | 16,251               | —                 | —  | 16,251                           |
| Other comprehensive loss   | —               | —                  | —                    | —                 | (15,757 )  | (15,757 )                        |
| Issuance of common stock for dividend<br>reinvestment plan (10,035 shares) | 12              | 341                | —                    | —                 | —  | 353                              |
| Stock compensation expense   | —               | 456                | —                    | —                 | —  | 456                              |
| Net issuance of common stock under employee<br>stock plans (42,179 shares) | —               | 417                | (25 )                | 369               | —  | 761                              |
| Cash dividends paid on common stock (\$0.28<br>per share)                  | —               | —                  | (9,808 )             | —                 | —  | (9,808 )                         |
| Balance at March 31, 2018  | \$ 47,265       | \$ 758,653         | \$ 39,184            | \$ (46,736)       | \$ (51,970 )   | \$ 746,396                       |
| Balance at December 31, 2018   | \$ 47,307       | \$ 762,470         | \$ 64,797            | \$ (93,055)       | \$ (50,228 )   | \$ 731,291                       |
| Cumulative effect of accounting change                                     | —               | —                  | (16,452 )            | —                 | —  | (16,452 )                        |
| Adjusted beginning balance   | 47,307          | 762,470            | 48,345               | (93,055 )         | (50,228 )  | 714,839                          |
| Net income   | —               | —                  | 18,817               | —                 | —  | 18,817                           |
| Other comprehensive income   | —               | —                  | —                    | —                 | 34,455   | 34,455                           |
| Issuance of common stock for dividend<br>reinvestment plan (10,565 shares) | 13              | 342                | —                    | —                 | —  | 355                              |
| Purchase of common stock (40,852 shares)                                   | —               | —                  | —                    | (1,325 )          | —  | (1,325 )                         |
| Stock compensation expense   | —               | 661                | —                    | —                 | —  | 661                              |
| Net issuance of common stock under employee<br>stock plans (23,617 shares) | —               | 109                | (32 )                | 261               | —  | 338                              |
| Cash dividends paid on common stock (\$0.30<br>per share)                  | —               | —                  | (10,107 )            | —                 | —  | (10,107 )                        |
| Balance at March 31, 2019  | \$ 47,320       | \$ 763,582         | \$ 57,023            | \$ (94,119)       | \$ (15,773 )   | \$ 758,033                       |

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 FLOWS  
(UNAUDITED)  
(in thousands)

|   | Three Months<br>Ended<br>March 31, |           |
|---|------------------------------------|-----------|
|   | 2019                               | 2018      |
| <b>OPERATING ACTIVITIES:</b>  |                                    |           |
| Net income  | \$18,817                           | \$16,251  |
| Adjustments to reconcile net income to net cash provided by operations: |                                    |           |
| Depreciation and net amortization                                       | 3,023                              | 3,566     |
| Securities premium amortization (discount accretion), net               | 3,448                              | 4,058     |
| Loan (discount accretion) premium amortization, net                     | (438 )                             | (1,057 )  |
| Provision for loan losses   | (918 )                             | 3,735     |
| Stock compensation expense  | 661                                | 456       |
| Deferred tax expense (benefit)  | 126                                | (255 )    |
| Net (gain) loss on sale of securities available for sale                | (256 )                             | 827       |
| Net loss on premises and equipment                                      | 5                                  | 35        |
| Gross proceeds from sales of loans held for sale                        | 4,244                              | 5,600     |
| Gross originations of loans held for sale                               | (4,027 )                           | (5,602 )  |
| Net (gain) loss on other real estate owned                              | (92 )                              | 67        |
| Net change in:  |                                    |           |
| Interest receivable   | 7,270                              | 7,827     |
| Other assets  | 3,305                              | 1,875     |
| Interest payable  | (321 )                             | (1,219 )  |
| Other liabilities   | (14,373 )                          | 5,501     |
| Net cash provided by operating activities                               | 20,474                             | 41,665    |
| <b>INVESTING ACTIVITIES:</b>  |                                    |           |
| Securities available for sale:  |                                    |           |
| Purchases   | (372,465)                          | (138,581) |
| Sales   | 436,182                            | 237,526   |
| Maturities, calls and principal repayments                              | 30,077                             | 53,717    |
| Securities held to maturity:  |                                    |           |
| Maturities, calls and principal repayments                              | 15,405                             | 1,222     |
| Proceeds from redemption of FHLB stock and other investments            | 8,788                              | 13,377    |
| Purchases of FHLB stock and other investments                           | (11,551 )                          | (638 )    |
| Net loan paydowns (originations)  | 5,868                              | (15,154 ) |
| Purchases of premises and equipment                                     | (4,040 )                           | (2,018 )  |
| Proceeds from sales of premises and equipment                           | 2                                  | 1,903     |
| Proceeds from sales of other real estate owned                          | 470                                | 91        |
| Proceeds from sales of repossessed assets                               | 137                                | 198       |
| Net cash provided by investing activities                               | 108,873                            | 151,643   |

(continued)



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

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | 2019                            | 2018        |
| <b>FINANCING ACTIVITIES:</b>  |                                 |             |
| Net change in deposits  | \$ 157,991                      | \$ 126,372  |
| Net decrease in federal funds purchased and repurchase agreements                 | (28,173 )                       | (1,673 )    |
| Proceeds from FHLB borrowings   | 1,556,293                       | 1,110,000   |
| Repayment of FHLB borrowings  | (1,655,495)                     | (1,355,194) |
| Proceeds from stock option exercises  | 412                             | 801         |
| Cash paid to tax authority related to tax withholding on share-based awards       | (74 )                           | (40 )       |
| Purchase of common stock  | (1,325 )                        | —           |
| Proceeds from the issuance of common stock for dividend reinvestment plan         | 355                             | 353         |
| Cash dividends paid   | (10,107 )                       | (9,808 )    |
| Net cash provided by (used in) financing activities                               | 19,877                          | (129,189 )  |
| Net increase in cash and cash equivalents   | 149,224                         | 64,119      |
| Cash and cash equivalents at beginning of period                                  | 120,719                         | 198,692     |
| Cash and cash equivalents at end of period  | \$ 269,943                      | \$ 262,811  |
| <b>SUPPLEMENTAL DISCLOSURES FOR CASH FLOW INFORMATION:</b>                        |                                 |             |
| Interest paid   | \$ 18,224                       | \$ 14,280   |
| Income taxes paid   | \$ —                            | \$ —        |
| <b>SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b>    |                                 |             |
| Loans transferred to other repossessed assets and real estate through foreclosure | \$ 336                          | \$ 649      |
| Transfer of held to maturity securities to available for sale securities          | \$ —                            | \$ 743,421  |
| Adjustment to pension liability   | \$(541 )                        | \$(473 )    |
| Unsettled trades to purchase securities   | \$(55,826 )                     | \$(3,646 )  |
| Unsettled trades to sell securities   | \$ 95,482                       | \$ 35,307   |

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, including Southside Bank. 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, and its wholly-owned subsidiary, OmniAmerican Bank, acquired by Southside on December 17, 2014. “Diboll” refers to Diboll State Bancshares, Inc., a bank holding company and its wholly-owned subsidiary, First Bank & Trust East Texas, acquired by Southside on November 30, 2017.

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States (“U.S.”) generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, not all information required by GAAP for complete financial statements is included in these interim statements. 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. The preparation of these consolidated financial statements in accordance with 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.

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, 2018.

Accounting Changes and Reclassifications

Certain prior period amounts may be reclassified to conform to current year presentation.

Debt Securities

We adopted Accounting Standards Update (“ASU”) 2017-08, “Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities,” on January 1, 2019, the effective date of the guidance. Under previous GAAP, premiums on callable debt securities were 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. The guidance requires companies to apply the requirements on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Adoption of this guidance on January 1, 2019, resulted in a cumulative-effect adjustment to reduce retained earnings by \$16.5 million, before tax. Subsequent to January 1, 2019, we sold the majority of the securities impacted by ASU 2017-08, and thus, the standard did not materially impact our consolidated net income.

Leases

We evaluate our contracts at inception to determine if an arrangement is or contains a lease. Operating leases are included in operating lease right-of-use (“ROU”) assets and operating lease liabilities in our consolidated balance sheets. The Company has no finance leases.

ROU assets represent our right to use an underlying asset for the lease term, and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. Our leases do not provide an implicit rate, so we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The incremental borrowing rate is reevaluated upon lease modification. The operating lease ROU asset also includes any initial direct costs and prepaid lease payments made less any lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably

certain that we will exercise that option.

We adopted ASU 2016-02, "Leases (Topic 842)," on January 1, 2019, the effective date of the guidance, using the practical expedient transition method whereby we did not revise comparative period information or disclosure. The new standard requires lessees to record assets and liabilities on the balance sheet for all leases with terms longer than 12 months. We elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to carryforward the historical lease classification. We also elected certain optional practical expedients including the hindsight practical expedient under which we considered the actual outcomes of lease renewals and terminations when measuring the lease term at adoption, and we made an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. We recognize these lease payments in the consolidated statements of income on a straight-line basis over the lease

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term. We have lease agreements with lease and non-lease components, and we have elected the practical expedient to account for these as a single lease component.

Our operating leases relate primarily to bank branches and office space. In conjunction with the adoption on January 1, 2019, we recognized operating lease liabilities of \$10.1 million and related lease assets of \$9.8 million on our balance sheet. The difference between the lease assets and lease liabilities primarily consists of deferred rent liabilities reclassified upon adoption to reduce the measurement of the lease assets. The standard did not materially impact our consolidated net income and had no impact on cash flows.

Accounting Pronouncements

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 AFS 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 a cumulative-effect 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. We plan to adopt on January 1, 2020, the effective date. We have developed a project plan and have assigned a project team to complete the analysis needed to implement the guidance. We are also currently working with a third party vendor solution to assist with the application of ASU 2016-13. The team is currently completing the data collection and anticipates running parallel models during 2019.

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 material impact on our consolidated financial statements.

2. Acquisition

On November 30, 2017, we acquired 100% of the outstanding stock of Diboll State Bancshares, Inc. and its wholly-owned subsidiary First Bank & Trust East Texas (collectively, “Diboll”) headquartered in Diboll, Texas. Diboll operated 17 banking offices in Diboll and surrounding areas. We acquired Diboll to further expand our presence in the East Texas market. The total merger consideration for the Diboll merger was \$224.3 million. The operations of Diboll were merged into the Company as of the date of the acquisition.

The fair value of assets acquired, adjusted for subsequent measurement period adjustments, excluding goodwill, totaled \$1.03 billion, including total loans of \$621.3 million and total investment securities of \$234.4 million. Total fair value of the liabilities assumed totaled \$910.7 million, including deposits of \$899.3 million. We recognized goodwill of \$109.6 million associated with Diboll acquisition. The goodwill resulting from the acquisition represents the value expected from the expansion of our markets into the Southeast Texas region and the enhancement of our operations through customer synergies and efficiencies, thereby providing enhanced customer service. Goodwill was \$201.1 million as of March 31, 2019 and December 31, 2018 and is not expected to be deductible for tax purposes. We recognized a core deposit intangible of \$14.7 million and a trust relationship intangible of \$5.4 million which we are amortizing using an accelerated method over a 9- and 13-year weighted average amortization period, respectively, consistent with expected future cash flows.

The Diboll acquisition was accounted for using the acquisition method of accounting and accordingly, purchased assets, including identifiable intangible assets and assumed liabilities, were recorded at their respective acquisition date fair values. For more information concerning the fair value of the assets acquired and liabilities assumed in relation to the acquisition of Diboll, see “Note 2 - Acquisition” in our Annual Report on Form 10-K for the year ended December 31, 2018.



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## 3. Earnings Per Share

Earnings per share on a basic and diluted basis are calculated as follows (in thousands, except per share amounts):

|   | Three Months<br>Ended<br>March 31, |          |
|---|------------------------------------|----------|
|   | 2019                               | 2018     |
| Basic and Diluted Earnings:                 |                                    |          |
| Net income                                  | \$18,817                           | \$16,251 |
| Basic weighted-average shares outstanding   | 33,697                             | 35,022   |
| Add: Stock awards                           | 149                                | 178      |
| Diluted weighted-average shares outstanding | 33,846                             | 35,200   |
| Basic earnings per share:                   |                                    |          |
| Net Income                                  | \$0.56                             | \$0.46   |
| Diluted earnings per share:                 |                                    |          |
| Net Income                                  | \$0.56                             | \$0.46   |

For the three months ended March 31, 2019 and 2018, there were approximately 490,000 and 186,000 anti-dilutive shares, respectively.

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## 4. Accumulated Other Comprehensive Income (Loss)

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

|  | Three Months Ended March 31, 2019                   |   |  |                    |             |
|--|---|---|--|--------------------|-------------|
|  | Unrealized<br>Gains<br>(Losses)<br>on<br>Securities | Unrealized<br>Gains<br>(Losses) on<br>Derivatives | Pension Plans<br>Net<br>Prior<br>Service<br>(Cost)<br>Credit | Net Gain<br>(Loss) | Total       |
| Beginning balance, net of tax                                    | \$ (31,120)   | \$ 7,146  | \$ (139)   | \$ (26,115)        | \$ (50,228) |
| Other comprehensive income (loss):                               |   |   |  |                    |             |
| Other comprehensive income (loss) before reclassifications       | 46,626  | (3,120 )  | —  | —                  | 43,506      |
| Reclassified from accumulated other comprehensive income (loss)  | 235   | (668 )  | (1 )   | 542                | 108         |
| Income tax (expense) benefit                                     | (9,840 )  | 795   | —  | (114 )             | (9,159 )    |
| Net current-period other comprehensive income (loss), net of tax | 37,021  | (2,993 )  | (1 )   | 428                | 34,455      |
| Ending balance, net of tax                                       | \$ 5,901  | \$ 4,153  | \$ (140)   | \$ (25,687)        | \$ (15,773) |
|  | Three Months Ended March 31, 2018                   |   |  |                    |             |
|  | Unrealized<br>Gains<br>(Losses)<br>on<br>Securities | Unrealized<br>Gains<br>(Losses) on<br>Derivatives | Pension Plans<br>Net<br>Prior<br>Service<br>(Cost)<br>Credit | Net Gain<br>(Loss) | Total       |
| Beginning balance, net of tax                                    | \$ (16,295)   | \$ 6,399  | \$ (133)   | \$ (26,269)        | \$ (36,298) |
| Cumulative effect of ASU 2016-01 <sup>(1)</sup>                  | 85  | —   | —  | —                  | 85          |
| Adjusted beginning balance, net of tax                           | (16,210 )   | 6,399   | (133 )   | (26,269 )          | (36,213 )   |
| Other comprehensive income (loss):                               |   |   |  |                    |             |
| Other comprehensive income (loss) before reclassifications       | (25,501 )   | 4,245   | —  | —                  | (21,256 )   |
| Reclassified from accumulated other comprehensive income (loss)  | 965   | (127 )  | (2 )   | 475                | 1,311       |
| Income tax benefit (expense)                                     | 5,152   | (865 )  | 1  | (100 )             | 4,188       |
| Net current-period other comprehensive (loss) income, net of tax | (19,384 )   | 3,253   | (1 )   | 375                | (15,757 )   |
| Ending balance, net of tax                                       | \$ (35,594)   | \$ 9,652  | \$ (134)   | \$ (25,894)        | \$ (51,970) |

(1) The Company adopted ASU 2016-01 on January 1, 2018. This amount includes a reclassification for the cumulative adjustment to retained earnings of \$107,000 (\$85,000, net of tax).

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

|  | Three Months<br>Ended<br>March 31,<br>2019    2018 |           |
|--|--|-----------|
| Unrealized losses on securities transferred:   |  |           |
| Amortization of unrealized losses <sup>(1)</sup>   | \$(491)  | \$(138 )  |
| Tax benefit  | 103  | 29        |
| Net of tax   | \$(388)  | \$(109 )  |
| Unrealized gains and losses on available for sale securities:                                |  |           |
| Realized net gain (loss) on sale of securities <sup>(2)</sup>                                | \$256  | \$(827 )  |
| Tax (expense) benefit  | (54 )  | 174       |
| Net of tax   | \$202  | \$(653 )  |
| Derivatives:   |  |           |
| Realized net gain on interest rate swap derivatives <sup>(3)</sup>                           | \$646  | \$106     |
| Tax expense  | (136 )   | (22 )     |
| Net of tax   | \$510  | \$84      |
| Amortization of unrealized gains on terminated interest rate swap derivatives <sup>(3)</sup> | \$22   | \$21      |
| Tax expense  | (5 )   | (4 )      |
| Net of tax   | \$17   | \$17      |
| Amortization of pension plan:  |  |           |
| Net actuarial loss <sup>(4)</sup>  | \$(542)  | \$(475 )  |
| Prior service credit <sup>(4)</sup>  | 1  | 2         |
| Total before tax   | (541 )   | (473 )    |
| Tax benefit  | 114  | 99        |
| Net of tax   | (427 )   | (374 )    |
| Total reclassifications for the period, net of tax   | \$(86 )  | \$(1,035) |

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

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

(3) Included in interest expense for FHLB borrowings 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 9 - Employee Benefit Plans."

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## 5. Securities

## Debt securities

The amortized cost, gross unrealized gains and losses and estimated fair value of investment and mortgage-backed securities available for sale and held to maturity as of March 31, 2019 and December 31, 2018 are reflected in the tables below (in thousands):

|  | March 31, 2019 |                     |                     |             |
|--|----------------|---------------------|---------------------|-------------|
|  | Amortized      | Gross<br>Unrealized | Gross<br>Unrealized | Estimated   |
| AVAILABLE FOR SALE                         | Cost           | Gains               | Losses              | Fair Value  |
| Investment securities:                     |                |                     |                     |             |
| State and political subdivisions           | \$446,006      | \$ 9,130            | \$ 1,865            | \$453,271   |
| Other stocks and bonds                     | 3,000          | —                   | 79                  | 2,921       |
| Mortgage-backed securities: <sup>(1)</sup> |                |                     |                     |             |
| Residential                                | 999,201        | 8,669               | 4,168               | 1,003,702   |
| Commercial                                 | 416,618        | 910                 | 1,167               | 416,361     |
| Total                                      | \$1,864,825    | \$ 18,709           | \$ 7,279            | \$1,876,255 |
| <b>HELD TO MATURITY</b>                    |                |                     |                     |             |
| Investment securities:                     |                |                     |                     |             |
| State and political subdivisions           | \$3,025        | \$ 29               | \$ —                | \$3,054     |
| Mortgage-backed securities: <sup>(1)</sup> |                |                     |                     |             |
| Residential                                | 59,720         | 962                 | 413                 | 60,269      |
| Commercial                                 | 84,686         | 514                 | 857                 | 84,343      |
| Total                                      | \$147,431      | \$ 1,505            | \$ 1,270            | \$147,666   |

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|  | December 31, 2018 |                              |                               |                         |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
| <b>AVAILABLE FOR SALE</b>                  |                   |                              |                               |                         |
| Investment securities:                     |                   |                              |                               |                         |
| State and political subdivisions           | \$728,142         | \$ 6,115                     | \$ 17,656                     | \$716,601               |
| Other stocks and bonds                     | 3,000             | —                            | 291                           | 2,709                   |
| Mortgage-backed securities: <sup>(1)</sup> |                   |                              |                               |                         |
| Residential                                | 738,585           | 3,498                        | 9,111                         | 732,972                 |
| Commercial                                 | 543,758           | 941                          | 7,545                         | 537,154                 |
| Total                                      | \$2,013,485       | \$ 10,554                    | \$ 34,603                     | \$1,989,436             |
| <b>HELD TO MATURITY</b>                    |                   |                              |                               |                         |
| Investment securities:                     |                   |                              |                               |                         |
| State and political subdivisions           | \$3,083           | \$ 5                         | \$ 42                         | \$3,046                 |
| Mortgage-backed securities: <sup>(1)</sup> |                   |                              |                               |                         |
| Residential                                | 59,655            | 154                          | 1,140                         | 58,669                  |
| Commercial                                 | 100,193           | 201                          | 2,328                         | 98,066                  |
| Total                                      | \$162,931         | \$ 360                       | \$ 3,510                      | \$159,781               |

(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 have transferred securities from AFS to HTM due to overall balance sheet strategies. The remaining net unamortized, unrealized loss on the transferred securities included in AOCI in the accompanying balance sheets totaled \$4.0 million (\$3.1 million, net of tax) at March 31, 2019 and \$15.3 million (\$12.1 million, net of tax) at December 31, 2018. Any net unrealized gain or loss on the transferred securities included in AOCI 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. Securities transferred with losses included in AOCI 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 three months ended March 31, 2019 or the year ended December 31, 2018.

On January 1, 2019, we adopted ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities," and in conjunction with the adoption recognized a cumulative effect adjustment to reduce retained earnings by \$16.5 million, before tax, related to premiums on callable debt securities. Prior to January 1, 2019, premiums were amortized over the contractual life of the security. With the adoption of ASU 2017-08, premiums on debt securities will be amortized to the earliest call date.

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The following tables represent the estimated fair value and unrealized loss on investment and mortgage-backed securities AFS and HTM as of March 31, 2019 and December 31, 2018 (in thousands):

| March 31, 2019                   |                     |                     |             |                 |             |                 |
|----------------------------------|---------------------|---------------------|-------------|-----------------|-------------|-----------------|
|                                  | Less Than 12 Months | More Than 12 Months | Total       |                 |             |                 |
|                                  | Fair Value          | Unrealized Loss     | Fair Value  | Unrealized Loss | Fair Value  | Unrealized Loss |
| <b>AVAILABLE FOR SALE</b>        |                     |                     |             |                 |             |                 |
| Investment securities:           |                     |                     |             |                 |             |                 |
| State and political subdivisions | \$241               | \$ —                | \$91,310    | \$ 1,865        | \$91,551    | \$ 1,865        |
| Other stocks and bonds           | 2,921               | 79                  | —           | —               | 2,921       | 79              |
| Mortgage-backed securities:      |                     |                     |             |                 |             |                 |
| Residential                      | 14,666              | 83                  | 314,543     | 4,085           | 329,209     | 4,168           |
| Commercial                       | —                   | —                   | 186,267     | 1,167           | 186,267     | 1,167           |
| Total                            | \$17,828            | \$ 162              | \$592,120   | \$ 7,117        | \$609,948   | \$ 7,279        |
| <b>HELD TO MATURITY</b>          |                     |                     |             |                 |             |                 |
| Mortgage-backed securities:      |                     |                     |             |                 |             |                 |
| Residential                      | \$1,213             | \$ 18               | \$4,759     | \$ 395          | \$5,972     | \$ 413          |
| Commercial                       | —                   | —                   | 44,916      | 857             | 44,916      | 857             |
| Total                            | \$1,213             | \$ 18               | \$49,675    | \$ 1,252        | \$50,888    | \$ 1,270        |
| <br>                             |                     |                     |             |                 |             |                 |
| December 31, 2018                |                     |                     |             |                 |             |                 |
|                                  | Less Than 12 Months | More Than 12 Months | Total       |                 |             |                 |
|                                  | Fair Value          | Unrealized Loss     | Fair Value  | Unrealized Loss | Fair Value  | Unrealized Loss |
| <b>AVAILABLE FOR SALE</b>        |                     |                     |             |                 |             |                 |
| Investment securities:           |                     |                     |             |                 |             |                 |
| State and political subdivisions | \$98,112            | \$ 899              | \$399,205   | \$ 16,757       | \$497,317   | \$ 17,656       |
| Other stocks and bonds           | 2,709               | 291                 | —           | —               | 2,709       | 291             |
| Mortgage-backed securities:      |                     |                     |             |                 |             |                 |
| Residential                      | 5,552               | 27                  | 488,334     | 9,084           | 493,886     | 9,111           |
| Commercial                       | 9,529               | 30                  | 457,704     | 7,515           | 467,233     | 7,545           |
| Total                            | \$115,902           | \$ 1,247            | \$1,345,243 | \$ 33,356       | \$1,461,145 | \$ 34,603       |
| <b>HELD TO MATURITY</b>          |                     |                     |             |                 |             |                 |
| Investment securities:           |                     |                     |             |                 |             |                 |
| State and political subdivisions | \$235               | \$ 1                | \$2,022     | \$ 41           | \$2,257     | \$ 42           |
| Mortgage-backed securities:      |                     |                     |             |                 |             |                 |
| Residential                      | 4,826               | 60                  | 51,046      | 1,080           | 55,872      | 1,140           |
| Commercial                       | 399                 | 2                   | 89,168      | 2,326           | 89,567      | 2,328           |
| Total                            | \$5,460             | \$ 63               | \$142,236   | \$ 3,447        | \$147,696   | \$ 3,510        |

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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 AFS and HTM 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 March 31, 2019.

The majority of the securities in an unrealized loss position are highly rated Texas municipal securities and U.S. Agency 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 March 31, 2019.

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

|                                     | Three Months<br>Ended<br>March 31, |           |
|-------------------------------------|------------------------------------|-----------|
|                                     | 2019                               | 2018      |
| U.S. Treasury                       | \$—                                | \$ 108    |
| U.S. government agency debentures   | —                                  | 89        |
| State and political subdivisions    | 4,118                              | 6,381     |
| Other stocks and bonds              | 28                                 | 30        |
| Mortgage-backed securities          | 12,474                             | 10,894    |
| Total interest income on securities | \$ 16,620                          | \$ 17,502 |

There was a \$256,000 net realized gain from the AFS securities portfolio for the three months ended March 31, 2019, which consisted of \$5.0 million in realized gains and \$4.8 million in realized losses. There was an \$827,000 net realized loss from the AFS securities portfolio for the three months ended March 31, 2018, which consisted of \$1.8 million in realized losses and \$941,000 in realized gains. There were no sales from the HTM portfolio during the three months ended March 31, 2019 or 2018. We calculate realized gains and losses on sales of securities under the specific identification method.

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The amortized cost and estimated fair value of AFS and HTM securities at March 31, 2019, 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.

|  | March 31, 2019    |             |
|--|-------------------|-------------|
|  | Amortized<br>Cost | Fair Value  |
| <b>AVAILABLE FOR SALE</b>              |                   |             |
| Investment securities:                 |                   |             |
| Due in one year or less                | \$3,827           | \$3,866     |
| Due after one year through five years  | 7,743             | 7,741       |
| Due after five years through ten years | 29,416            | 30,332      |
| Due after ten years                    | 408,020           | 414,253     |
|  | 449,006           | 456,192     |
| Mortgage-backed securities             | 1,415,819         | 1,420,063   |
| Total                                  | \$1,864,825       | \$1,876,255 |

|  | March 31, 2019    |               |
|--|-------------------|---------------|
|  | Amortized<br>Cost | Fair<br>Value |
| <b>HELD TO MATURITY</b>                |                   |               |
| Investment securities:                 |                   |               |
| Due in one year or less                | \$115             | \$115         |
| Due after one year through five years  | 1,663             | 1,676         |
| Due after five years through ten years | 1,247             | 1,263         |
| Due after ten years                    | —                 | —             |
|  | 3,025             | 3,054         |
| Mortgage-backed securities:            | 144,406           | 144,612       |
| Total                                  | \$147,431         | \$147,666     |

Investment securities and MBS with carrying values of \$1.03 billion and \$1.08 billion were pledged as of March 31, 2019 and December 31, 2018, respectively, to collateralize Federal Home Loan Bank of Dallas (“FHLB”) borrowings, repurchase agreements and public funds or for other purposes as required by law.

## Equity Investments

Equity investments on our consolidated balance sheets include Community Reinvestment Act funds with a readily determinable fair value as well as equity investments without readily determinable fair values. At March 31, 2019 and December 31, 2018, we had equity investments recorded in our consolidated balance sheets of \$12.2 million and \$12.1 million, respectively.

Any realized and unrealized gains and losses on equity investments are reported in income. Equity investments without readily determinable fair values are recorded at cost less any impairment, if any.





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The following is a summary of unrealized and realized gains and losses on equity investments recognized in other noninterest income in the consolidated statements of income during the three months ended March 31, 2019 (in thousands):

|   | Three<br>Months<br>Ended<br>March 31,<br>2019 | 2018   |
|---|---|--------|
| Net gains (losses) recognized during the period on equity investments   | \$76  | \$(92) |
| Less: Net gains (losses) recognized during the period on equity investments sold during the period                      | —   | —      |
| Unrealized gains (losses) recognized during the reporting period on equity investments still held at the reporting date | \$76  | \$(92) |

Equity investments are assessed quarterly for other-than-temporary impairment. Based upon that evaluation, management does not consider any of our equity investments to be other-than-temporarily impaired at March 31, 2019.

#### Federal Home Loan Bank Stock

Our FHLB stock, which has limited marketability, is carried at cost.

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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):

|  | March 31,<br>2019 | December 31,<br>2018 |
|--|-------------------|----------------------|
| Real estate loans:                             |                   |                      |
| Construction                                   | \$603,411         | \$ 507,732           |
| 1-4 family residential                         | 786,198           | 794,499              |
| Commercial                                     | 1,104,378         | 1,194,118            |
| Commercial loans                               | 367,995           | 356,649              |
| Municipal loans                                | 343,026           | 353,370              |
| Loans to individuals                           | 100,102           | 106,431              |
| Total loans                                    | 3,305,110         | 3,312,799            |
| Less: Allowance for loan losses <sup>(1)</sup> | 24,155            | 27,019               |
| Net loans                                      | \$3,280,955       | \$ 3,285,780         |

<sup>(1)</sup> The allowance for loan loss recorded on purchased credit impaired (“PCI”) loans totaled \$250,000 and \$302,000 as of March 31, 2019 and December 31, 2018, respectively.

**Construction Real Estate 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.

**1-4 Family Residential Real Estate 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 March 31, 2019 consisted of \$1.05 billion of owner and non-owner occupied real estate, \$34.9 million of loans secured by multi-family properties and \$17.3 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. Management does not consider there to be a risk in any one industry type. 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, with a small percentage originating outside of the state. 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. Lending money directly to these municipalities allows us to earn a higher yield than we could if we purchased municipal securities for similar durations.

### 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 assists 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 the review we determine it is probable 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 allowance. 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 loans.

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

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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.

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 loan 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 non-PCI purchased 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 March 31, 2019 |                        |            |                  |                 |                      |          |
|---|-----------------------------------|------------------------|------------|------------------|-----------------|----------------------|----------|
|   | Real Estate                       |                        |            |                  |                 |                      |          |
|   | Construction                      | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total    |
| Balance at beginning of period                      | \$3,597                           | \$ 3,844               | \$ 13,968  | \$ 3,974         | \$ 525          | \$ 1,111             | \$27,019 |
| Provision (reversal) for loan losses <sup>(2)</sup> | 662                               | (447 )                 | (2,112 )   | 734              | (17 )           | 262                  | (918 )   |
| Loans charged off                                   | —                                 | (18 )                  | (1,215 )   | (451 )           | —               | (601 )               | (2,285 ) |
| Recoveries of loans charged off                     | —                                 | 3                      | 19         | 30               | —               | 287                  | 339      |
| Balance at end of period                            | \$4,259                           | \$ 3,382               | \$ 10,660  | \$ 4,287         | \$ 508          | \$ 1,059             | \$24,155 |

  

|   | Three Months Ended March 31, 2018 |                        |            |                  |                 |                      |          |
|---|-----------------------------------|------------------------|------------|------------------|-----------------|----------------------|----------|
|   | Real Estate                       |                        |            |                  |                 |                      |          |
|   | Construction                      | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total    |
| Balance at beginning of period <sup>(1)</sup>       | \$3,676                           | \$ 2,445               | \$ 10,821  | \$ 2,094         | \$ 860          | \$ 885               | \$20,781 |
| Provision (reversal) for loan losses <sup>(2)</sup> | (65 )                             | (82 )                  | 3,266      | 333              | (9 )            | 292                  | 3,735    |
| Loans charged off                                   | (14 )                             | —                      | —          | (85 )            | —               | (668 )               | (767 )   |
| Recoveries of loans charged off                     | —                                 | 14                     | 2          | 43               | —               | 412                  | 471      |
| Balance at end of period                            | \$3,597                           | \$ 2,377               | \$ 14,089  | \$ 2,385         | \$ 851          | \$ 921               | \$24,220 |

(1) Loans acquired with the Diboll acquisition were measured at fair value on November 30, 2017 with no carryover of allowance for loan loss.

Of the \$918,000 reversal of provision for loan losses for the three months ended March 31, 2019, \$52,000 related (2) to provision expense reversed on PCI loans. Of the \$3.7 million recorded in provision for loan losses for the three months ended March 31, 2018, none related to provision expense on PCI loans.

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

|   | March 31, 2019 |                        |            |                  |                 |                      |          |
|---|----------------|------------------------|------------|------------------|-----------------|----------------------|----------|
|   | Real Estate    |                        |            |                  |                 |                      |          |
|   | Construction   | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total    |
| Ending balance – individually evaluated for impairment <sup>(1)</sup> | \$13           | \$ 83                  | \$ 3,100   | \$ 403           | \$ 1            | \$ 150               | \$3,750  |
| Ending balance – collectively evaluated for impairment                | 4,246          | 3,299                  | 7,560      | 3,884            | 507             | 909                  | 20,405   |
| Balance at end of period  | \$4,259        | \$ 3,382               | \$ 10,660  | \$ 4,287         | \$ 508          | \$ 1,059             | \$24,155 |

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|   | December 31, 2018 |                        |            |                  |                 |                      |           |
|---|-------------------|------------------------|------------|------------------|-----------------|----------------------|-----------|
|   | Real Estate       |                        |            |                  |                 |                      |           |
|   | Construction      | 1-4 Family Residential | Commercial | Commercial Loans | Municipal Loans | Loans to Individuals | Total     |
| Ending balance – individually evaluated for impairment <sup>(1)</sup> | \$ 13             | \$ 40                  | \$ 5,337   | \$ 368           | \$ 1            | \$ 149               | \$ 5,908  |
| Ending balance – collectively evaluated for impairment                | 3,584             | 3,804                  | 8,631      | 3,606            | 524             | 962                  | 21,111    |
| Balance at end of period  | \$3,597           | \$ 3,844               | \$ 13,968  | \$ 3,974         | \$ 525          | \$ 1,111             | \$ 27,019 |

(1) The allowance for loan loss on PCI loans totaled \$250,000 and \$302,000 as of March 31, 2019 and December 31, 2018, respectively.

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

|   | March 31, 2019    |                        |              |                  |                 |                      |              |
|---|-------------------|------------------------|--------------|------------------|-----------------|----------------------|--------------|
|   | Real Estate       |                        |              |                  |                 |                      |              |
|   | Construction      | 1-4 Family Residential | Commercial   | Commercial Loans | Municipal Loans | Loans to Individuals | Total        |
| Loans individually evaluated for impairment | \$ 8              | \$ 1,295               | \$ 23,282    | \$ 1,914         | \$ 429          | \$ 142               | \$ 27,070    |
| Loans collectively evaluated for impairment | 603,257           | 776,725                | 1,049,049    | 364,363          | 342,597         | 99,618               | 3,235,609    |
| Purchased credit impaired loans             | 146               | 8,178                  | 32,047       | 1,718            | —               | 342                  | 42,431       |
| Total ending loan balance                   | \$603,411         | \$ 786,198             | \$ 1,104,378 | \$ 367,995       | \$ 343,026      | \$ 100,102           | \$ 3,305,110 |
|   | December 31, 2018 |                        |              |                  |                 |                      |              |
|   | Real Estate       |                        |              |                  |                 |                      |              |
|   | Construction      | 1-4 Family Residential | Commercial   | Commercial Loans | Municipal Loans | Loans to Individuals | Total        |
| Loans individually evaluated for impairment | \$ 12             | \$ 1,215               | \$ 33,013    | \$ 1,394         | \$ 429          | \$ 184               | \$ 36,247    |
| Loans collectively evaluated for impairment | 507,564           | 782,614                | 1,128,220    | 353,036          | 352,941         | 105,775              | 3,230,150    |
| Purchased credit impaired loans             | 156               | 10,670                 | 32,885       | 2,219            | —               | 472                  | 46,402       |
| Total ending loan balance                   | \$507,732         | \$ 794,499             | \$ 1,194,118 | \$ 356,649       | \$ 353,370      | \$ 106,431           | \$ 3,312,799 |

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

| March 31, 2019         |             |                      |                           |                    |                 |             |
|------------------------|-------------|----------------------|---------------------------|--------------------|-----------------|-------------|
|                        | Pass        | Pass<br>Watch<br>(1) | Special<br>Mention<br>(1) | Substandard<br>(1) | Doubtful<br>(1) | Total       |
| Real estate loans:     |             |                      |                           |                    |                 |             |
| Construction           | \$603,239   | \$23                 | \$—                       | \$ 149             | \$—             | \$603,411   |
| 1-4 family residential | 780,827     | 35                   | 98                        | 4,439              | 799             | 786,198     |
| Commercial             | 1,004,085   | 25,844               | 26,948                    | 47,341             | 160             | 1,104,378   |
| Commercial loans       | 360,398     | 1,131                | 3,251                     | 3,129              | 86              | 367,995     |
| Municipal loans        | 343,026     | —                    | —                         | —                  | —               | 343,026     |
| Loans to individuals   | 99,504      | —                    | 2                         | 414                | 182             | 100,102     |
| Total                  | \$3,191,079 | \$27,033             | \$30,299                  | \$55,472           | \$1,227         | \$3,305,110 |
| December 31, 2018      |             |                      |                           |                    |                 |             |
|                        | Pass        | Pass<br>Watch<br>(1) | Special<br>Mention<br>(1) | Substandard<br>(1) | Doubtful<br>(1) | Total       |
| Real estate loans:     |             |                      |                           |                    |                 |             |
| Construction           | \$507,529   | \$163                | \$—                       | \$ 28              | \$ 12           | \$507,732   |
| 1-4 family residential | 787,516     | 37                   | 100                       | 5,489              | 1,357           | 794,499     |
| Commercial             | 1,067,874   | 11,479               | 26,490                    | 87,767             | 508             | 1,194,118   |
| Commercial loans       | 349,495     | 520                  | 3,189                     | 2,988              | 457             | 356,649     |
| Municipal loans        | 353,370     | —                    | —                         | —                  | —               | 353,370     |
| Loans to individuals   | 105,536     | 4                    | 4                         | 678                | 209             | 106,431     |
| Total                  | \$3,171,320 | \$12,203             | \$29,783                  | \$96,950           | \$2,543         | \$3,312,799 |

Includes PCI loans comprised of \$21,000 pass watch, \$308,000 special mention, \$2.9 million substandard and (1)\$317,000 doubtful as of March 31, 2019. Includes PCI loans comprised of \$22,000 pass watch, \$859,000 special mention, \$3.9 million substandard and \$1.2 million doubtful as of December 31, 2018.

#### 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 when the timing and amount of expected cash flows can be

reasonably estimated, 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 reassess 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.

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

|   | March 31, December 31, |           |
|---|------------------------|-----------|
|   | 2019                   | 2018      |
| Nonaccrual loans <sup>(1)</sup> <sup>(2)</sup>                          | \$ 17,691              | \$ 35,770 |
| Accruing loans past due more than 90 days <sup>(1)</sup> <sup>(3)</sup> | 7,927                  | —         |
| Restructured loans <sup>(4)</sup>                                       | 11,490                 | 5,930     |
| Other real estate owned   | 978                    | 1,206     |
| Reposessed assets   | 25                     | —         |
| Total nonperforming assets  | \$ 38,111              | \$ 42,906 |

(1) Excludes PCI loans measured at fair value at acquisition if the timing and amount of cash flows expected to be collected from those sales can be reasonably estimated.

(2) Includes \$10.7 million and \$10.9 million of restructured loans as of March 31, 2019 and December 31, 2018, respectively.

(3) The relationship comprising this figure subsequently paid off in the second quarter of 2019.

(4) Includes \$719,000 and \$3.1 million in PCI loans restructured as of March 31, 2019 and December 31, 2018, 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. There were \$155,000 and \$147,000 in loans secured by 1-4 family residential properties for which formal foreclosure proceedings were in process as of March 31, 2019 and December 31, 2018, respectively.

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 |                   |
|------------------------|------------------|-------------------|
|                        | March 31, 2019   | December 31, 2018 |
| Real estate loans:     |                  |                   |
| Construction           | \$ 8             | \$ 12             |
| 1-4 family residential | 1,395            | 2,202             |
| Commercial             | 15,266           | 32,599            |
| Commercial loans       | 758              | 639               |
| Loans to individuals   | 264              | 318               |
| Total                  | \$ 17,691        | \$ 35,770         |

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 larger 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.

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The following tables set forth impaired loans by class of loans, including the unpaid contractual principal balance, the recorded investment and the allowance for loan losses 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 March 31, 2019 or December 31, 2018.

|                        | March 31, 2019                                |                        |   |
|------------------------|---|------------------------|---|
|                        | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance<br>for<br>Loan<br>Losses |
| Real estate loans:     |   |                        |   |
| Construction           | \$ 169  | \$ 136                 | \$ 13   |
| 1-4 family residential | 8,742   | 7,576                  | 83  |
| Commercial             | 26,333  | 24,965                 | 3,100   |
| Commercial loans       | 3,139   | 2,527                  | 403   |
| Municipal loans        | 429   | 429                    | 1   |
| Loans to individuals   | 636   | 484                    | 150   |
| Total <sup>(1)</sup>   | \$39,448                                      | \$ 36,117              | \$ 3,750                                      |

|                        | December 31, 2018                             |                        |   |
|------------------------|---|------------------------|---|
|                        | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance<br>for<br>Loan<br>Losses |
| Real estate loans:     |   |                        |   |
| Construction           | \$ 182  | \$ 148                 | \$ 13   |
| 1-4 family residential | 6,507   | 5,923                  | 40  |
| Commercial             | 36,457  | 34,744                 | 5,337   |
| Commercial loans       | 2,874   | 2,366                  | 368   |
| Municipal loans        | 429   | 429                    | 1   |
| Loans to individuals   | 825   | 657                    | 149   |
| Total <sup>(1)</sup>   | \$47,274                                      | \$ 44,267              | \$ 5,908                                      |

(1) Includes \$9.0 million and \$8.0 million of PCI loans that experienced deterioration in credit quality subsequent to the acquisition date as of March 31, 2019 and December 31, 2018, respectively.

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

|                    | March 31, 2019               |                              |   |                      |                        |           |
|--------------------|------------------------------|------------------------------|---|----------------------|------------------------|-----------|
|                    | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>than 90<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Current <sup>(1)</sup> | Total     |
| Real estate loans: |                              |                              |   |                      |                        |           |
| Construction       | \$5,894                      | \$72                         | \$—                                       | \$5,966              | \$597,445              | \$603,411 |

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|                        |          |         |         |          |             |             |
|------------------------|----------|---------|---------|----------|-------------|-------------|
| 1-4 family residential | 11,506   | 270     | 305     | 12,081   | 774,117     | 786,198     |
| Commercial             | 895      | —       | 7,939   | 8,834    | 1,095,544   | 1,104,378   |
| Commercial loans       | 1,722    | 492     | 503     | 2,717    | 365,278     | 367,995     |
| Municipal loans        | —        | —       | —       | —        | 343,026     | 343,026     |
| Loans to individuals   | 1,144    | 206     | 62      | 1,412    | 98,690      | 100,102     |
| Total                  | \$21,161 | \$1,040 | \$8,809 | \$31,010 | \$3,274,100 | \$3,305,110 |

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|                        | December 31, 2018            |                              |   |                      |                        |             |
|------------------------|------------------------------|------------------------------|---|----------------------|------------------------|-------------|
|                        | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>than 90<br>Days<br>Past<br>Due | Total<br>Past<br>Due | Current <sup>(1)</sup> | Total       |
| Real estate loans:     |                              |                              |   |                      |                        |             |
| Construction           | \$627                        | \$307                        | \$—                                       | \$934                | \$506,798              | \$507,732   |
| 1-4 family residential | 7,441                        | 1,258                        | 1,335                                     | 10,034               | 784,465                | 794,499     |
| Commercial             | 10,663                       | 7,655                        | —   | 18,318               | 1,175,800              | 1,194,118   |
| Commercial loans       | 1,946                        | 705                          | 591                                       | 3,242                | 353,407                | 356,649     |
| Municipal loans        | —                            | —                            | —   | —                    | 353,370                | 353,370     |
| Loans to individuals   | 1,289                        | 351                          | 146                                       | 1,786                | 104,645                | 106,431     |
| Total                  | \$21,966                     | \$10,276                     | \$2,072                                   | \$34,314             | \$3,278,485            | \$3,312,799 |

(1) Includes PCI loans measured at fair value at acquisition if the timing and amount of cash flows expected to be collected from those sales can be reasonably estimated.

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                |   |                                   |   |
|------------------------|-----------------------------------|---|-----------------------------------|---|
|                        | March 31, 2019                    |   | March 31, 2018                    |   |
|                        | Average<br>Recorded<br>Investment | Average<br>Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Average<br>Interest<br>Income<br>Recognized |
| Real estate loans:     |                                   |   |                                   |   |
| Construction           | \$170                             | \$ 5  | \$78                              | \$ —  |
| 1-4 family residential | 5,336                             | 79  | 3,923                             | 41  |
| Commercial             | 35,951                            | 277   | 11,970                            | 3   |
| Commercial loans       | 2,602                             | 31  | 1,623                             | 17  |
| Municipal loans        | 429                               | 6   | 502                               | 7   |
| Loans to individuals   | 589                               | 9   | 211                               | 2   |
| Total                  | \$45,077                          | \$ 407                                      | \$18,307                          | \$ 70                                       |

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## 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 by class of loans during the periods presented (dollars in thousands):

|                        | Three Months Ended March 31, 2019 |                          |             |                     | Number of Loans |
|------------------------|-----------------------------------|--------------------------|-------------|---------------------|-----------------|
|                        | Extend Amortization Period        | Interest Rate Reductions | Combination | Total Modifications |                 |
| Real estate loans:     |                                   |                          |             |                     |                 |
| 1-4 family residential | \$—                               | \$                       | —\$ 113     | \$ 113              | 1               |
| Commercial             | 7,627                             | —                        | —           | 7,627               | 1               |
| Commercial loans       | 57                                | —                        | —           | 57                  | 1               |
| Loans to individuals   | —                                 | —                        | 15          | 15                  | 2               |
| Total                  | \$7,684                           | \$                       | —\$ 128     | \$ 7,812            | 5               |

|                      | Three Months Ended March 31, 2018 |                          |             |                     | Number of Loans |
|----------------------|-----------------------------------|--------------------------|-------------|---------------------|-----------------|
|                      | Extend Amortization Period        | Interest Rate Reductions | Combination | Total Modifications |                 |
| Commercial loans     | \$207                             | \$                       | —\$         | —\$ 207             | 3               |
| Loans to individuals | 104                               | —                        | —           | 104                 | 1               |
| Total                | \$311                             | \$                       | —\$         | —\$ 311             | 4               |

The majority of loans restructured as TDRs during the three months ended March 31, 2019 and 2018 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 three months ended March 31, 2019 and 2018 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 months ended March 31, 2019 and 2018, 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 March 31, 2019 and 2018, 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):

|                               | March 31, December 31, |           |
|-------------------------------|------------------------|-----------|
|                               | 2019                   | 2018      |
| Outstanding principal balance | \$ 47,034              | \$ 51,388 |
| Carrying amount               | \$ 42,431              | \$ 46,402 |

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

|   | Three Months<br>Ended<br>March 31, |           |
|---|------------------------------------|-----------|
|   | 2019                               | 2018      |
| Balance at beginning of period  | \$ 15,054                          | \$ 18,721 |
| Changes in expected cash flows not affecting non-accretable differences | —                                  | (1,445 )  |
| Reclassifications (to) from nonaccretable discount                      | 262                                | (320 )    |
| Accretion   | (796 )                             | (1,138 )  |
| Balance at end of period  | \$ 14,520                          | \$ 15,818 |

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## 7. Borrowing Arrangements

Information related to borrowings is provided in the table below (dollars in thousands):

|   | March 31,<br>2019 | December 31,<br>2018 |   |  |
|---|-------------------|----------------------|---|--|
| Federal funds purchased and repurchase agreements:              |                   |                      |   |  |
| Balance at end of period  | \$8,637           | \$36,810             |   |  |
| Average amount outstanding during the period <sup>(1)</sup>     | 16,788            | 10,880               |   |  |
| Maximum amount outstanding during the period <sup>(2)</sup>     | 28,354            | 36,810               |   |  |
| Weighted average interest rate during the period <sup>(3)</sup> | 1.8               | % 1.4                | % |  |
| Interest rate at end of period <sup>(4)</sup>                   | 1.1               | % 2.1                | % |  |
| FHLB borrowings:  |                   |                      |   |  |
| Balance at end of period  | \$619,861         | \$719,065            |   |  |
| Average amount outstanding during the period <sup>(1)</sup>     | 816,389           | 720,785              |   |  |
| Maximum amount outstanding during the period <sup>(2)</sup>     | 1,004,997         | 957,231              |   |  |
| Weighted average interest rate during the period <sup>(3)</sup> | 2.2               | % 1.8                | % |  |
| Interest rate at end of period <sup>(4)</sup>                   | 2.4               | % 2.3                | % |  |

(1) The average amount outstanding during the period was computed by dividing the total daily outstanding principal balances by the number of days in the period.

(2) The maximum amount outstanding at any month-end during the period.

The weighted average interest rate during the period was computed by dividing the actual interest expense (3) (annualized for interim periods) by the average amount outstanding during the period. The weighted average interest rate on the FHLB borrowings includes the effect of interest rate swaps.

(4) Stated rate.

Maturities of the obligations associated with our borrowing arrangements based on scheduled repayments at March 31, 2019 are as follows (in thousands):

|   | Payments Due by Period |           |              |              |              |            | Total     |
|---|------------------------|-----------|--------------|--------------|--------------|------------|-----------|
|   | Less than<br>1 Year    | 1-2 Years | 2-3<br>Years | 3-4<br>Years | 4-5<br>Years | Thereafter |           |
| Federal funds purchased and repurchase agreements | \$8,505                | \$132     | \$—          | \$—          | —\$          | —\$ —      | \$8,637   |
| FHLB borrowings                                   | 462,665                | 145,429   | 6,000        | —            | —            | 5,767      | 619,861   |
| Total obligations                                 | \$471,170              | \$145,561 | \$6,000      | \$—          | —\$          | —\$ 5,767  | \$628,498 |

FHLB borrowings represent borrowings with fixed and floating interest rates ranging from 1.37% to 4.799% and with remaining maturities of 5 days to 9.3 years at March 31, 2019. FHLB borrowings may be collateralized by FHLB stock, nonspecified loans and/or securities.

Southside Bank has entered into various variable rate advance agreements with the FHLB. These advance agreements totaled \$310.0 million at both March 31, 2019 and December 31, 2018. Three of the variable rate advance agreements have interest rates tied to three-month LIBOR and the remaining agreements have interest rates tied to one-month LIBOR. In connection with \$270.0 million of these variable rate advance agreements, Southside Bank also entered into various interest rate swap contracts that are treated as cash flow hedges under ASC Topic 815, "Derivatives and Hedging" that effectively convert the variable rate advance agreements to fixed interest rates that average 1.58% with an average weighted maturity of 4.6 years at March 31, 2019. 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.



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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 \$40.0 million, \$15.0 million and \$7.5 million, respectively. There were no federal funds purchased at March 31, 2019. There were \$28.0 million federal funds purchased at December 31, 2018. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit, and at March 31, 2019, we had one outstanding letter of credit for \$195,000. At March 31, 2019, the amount of additional funding Southside Bank could obtain from FHLB, collateralized by securities, FHLB stock and nonspecified loans and securities, was approximately \$1.34 billion, net of FHLB stock purchases required. Southside Bank currently has no outstanding letters of credit from FHLB held as collateral for its public fund deposits.

Southside Bank enters into sales of securities under agreements to repurchase (“repurchase agreements”). These repurchase agreements totaled \$8.6 million and \$8.8 million at March 31, 2019 and December 31, 2018, respectively, and had maturities of less than two years. These repurchase agreements are secured by investment securities and are stated at the amount of cash received in connection with the transaction.

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## 8. Long-term Debt

|                       | March 31, 2019 |  | December 31,<br>2018 |
|-----------------------|----------------|--|----------------------|
|                       | (in thousands) |  |                      |
| Subordinated notes:   |                |  |                      |
| (1)                   |                |  |                      |
| 5.50% Subordinated    |                |  |                      |
| Notes, net of         | \$ 98,448      |  | \$ 98,407            |
| unamortized debt      |                |  |                      |
| issuance costs (2)    |                |  |                      |
| Total Subordinated    | 98,448         |  | 98,407               |
| notes                 |                |  |                      |
| Trust preferred       |                |  |                      |
| subordinated          |                |  |                      |
| debentures: (3)       |                |  |                      |
| Southside Statutory   |                |  |                      |
| Trust III, net of     | 20,555         |  | 20,554               |
| unamortized debt      |                |  |                      |
| issuance costs (4)    |                |  |                      |
| Southside Statutory   | 23,196         |  | 23,196               |
| Trust IV              |                |  |                      |
| Southside Statutory   | 12,887         |  | 12,887               |
| Trust V               |                |  |                      |
| Magnolia Trust        | 3,609          |  | 3,609                |
| Company I             |                |  |                      |
| Total Trust preferred |                |  |                      |
| subordinated          | 60,247         |  | 60,246               |
| debentures            |                |  |                      |
| Total Long-term debt  | \$ 158,695     |  | \$ 158,653           |

(1) This 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) The unamortized discount and debt issuance costs reflected in the carrying amount of the subordinated notes totaled approximately \$1.6 million at March 31, 2019 and December 31, 2018.

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

(4) The unamortized debt issuance costs reflected in the carrying amount of the Southside Statutory Trust III junior subordinated debentures totaled \$64,000 at March 31, 2019 and \$65,000 at December 31, 2018.

As of March 31, 2019, the details of the subordinated notes and the trust preferred subordinated debentures are summarized below (dollars in thousands):

|                                  | Date Issued           | Amount<br>Issued | Fixed or Floating<br>Rate | Interest Rate            | Maturity Date         |
|----------------------------------|-----------------------|------------------|---------------------------|--------------------------|-----------------------|
| 5.50% Subordinated<br>Notes      | September 19,<br>2016 | \$ 100,000       | Fixed-to-Floating         | 5.50%                    | September 30,<br>2026 |
| Southside Statutory Trust<br>III | September 4,<br>2003  | \$ 20,619        | Floating                  | 3 month LIBOR +<br>2.94% | September 4,<br>2033  |
|                                  | August 8, 2007        | \$ 23,196        | Floating                  |                          | October 30, 2037      |

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|  |                  |          |          |                          |                       |
|--|------------------|----------|----------|--------------------------|-----------------------|
| Southside Statutory Trust<br>IV            |                  |          |          | 3 month LIBOR +<br>1.30% |                       |
| Southside Statutory Trust<br>V             | August 10, 2007  | \$12,887 | Floating | 3 month LIBOR +<br>2.25% | September 15,<br>2037 |
| Magnolia Trust Company<br>I <sup>(1)</sup> | October 10, 2007 | \$3,609  | Floating | 3 month LIBOR +<br>1.80% | November 23,<br>2035  |

(1) On October 10, 2007, as part of an acquisition we assumed \$3.6 million of floating rate junior subordinated debentures issued in 2005 to Magnolia Trust Company I.

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.



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## 9. Employee Benefit Plans

The components of net periodic benefit cost (income) related to our employee benefit plans are as follows (in thousands):

|  | Three Months Ended March 31, |         |                                       |        |                  |       |
|--|------------------------------|---------|---------------------------------------|--------|------------------|-------|
|  | Defined Benefit Pension Plan |         | Defined Benefit Pension Plan Acquired |        | Restoration Plan |       |
|  | 2019                         | 2018    | 2019                                  | 2018   | 2019             | 2018  |
| Service cost                             | \$316                        | \$384   | \$—                                   | \$—    | \$60             | \$63  |
| Interest cost                            | 908                          | 857     | 41                                    | 41     | 161              | 133   |
| Expected return on assets                | (1,504)                      | (1,620) | (73)                                  | (73)   | —                | —     |
| Net loss amortization                    | 443                          | 384     | —                                     | —      | 99               | 91    |
| Prior service (credit) cost amortization | (3)                          | (3)     | —                                     | —      | 2                | 1     |
| Net periodic benefit cost (income)       | \$160                        | \$2     | \$(32)                                | \$(32) | \$322            | \$288 |

The service cost component is recorded on our consolidated income statement as salaries and employee benefits in noninterest expense while all other components other than service cost are recorded in other noninterest expense.

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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, cash flow hedges of forecasted transactions or fair value hedges of a recognized asset or liability or as non-hedging instruments. Gains and losses on derivative instruments designated as cash flow hedges are recorded in AOCI 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. Gains and losses on derivative instruments designated as fair value hedges, as well as the change in fair value on the hedged item, are recorded in interest income in the consolidated statements of income. Gains and losses due to changes in fair value of the interest rate swap agreements completely offset changes in the fair value of the hedged portion of the hedged item. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change.

We have entered into certain interest rate swap contracts on specific variable rate FHLB advance agreements. 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 \$270.0 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.

During 2018, we entered into partial term fair value hedges for certain of our fixed rate callable available for sale municipal securities. These partial term hedges of selected cash flows covering the time periods to the call dates of the hedged securities were expected to be effective in offsetting changes in the fair value of the hedged securities. Interest rate swaps designated as partial-term fair value hedges were utilized to mitigate the effect of changing interest rates on the hedged securities. The hedging strategy converted a portion of the fixed interest rates on the securities to LIBOR-based variable interest rates. During the first quarter of 2019, our fair value hedging relationships were ineffective due to the sale of the hedged items. As a result of the sale, the cumulative adjustments to the carrying amount was a fair value loss recognized in earnings and recorded in interest income for the quarter ended March 31, 2019. The remaining fair value loss from the date of the sale of the hedged items through March 31, 2019, was recognized in earnings and recorded in noninterest income. As of March 31, 2019, the interest rate swaps were considered non-hedging instruments and were subsequently terminated on April 12, 2019.

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 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 AOCI shall be reclassified into earnings immediately. During 2017, we terminated two interest rate swap contracts designated as cash flow hedges. At the time of termination, we determined the underlying hedged forecasted transactions were still probable of occurring. The existing gain in AOCI will be reclassified into earnings in the same periods the hedged forecasted transaction affects earnings. These transactions are reevaluated on a monthly basis 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.

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. 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.

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At March 31, 2019, net derivative assets included \$3.4 million of cash collateral received from counterparties under master netting agreements and net derivative liabilities included \$2.2 million of cash collateral held by a counterparty to a master netting agreement. At March 31, 2019, we had \$531,000 of cash collateral receivable that was not offset against derivative liabilities.

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.

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

|   | March 31, 2019         |                  |                      | December 31, 2018      |                  |                      |
|---|------------------------|------------------|----------------------|------------------------|------------------|----------------------|
|   | Notional Amount<br>(1) | Asset Derivative | Liability Derivative | Notional Amount<br>(1) | Asset Derivative | Liability Derivative |
| Derivatives designated as hedging instruments                   |                        |                  |                      |                        |                  |                      |
| Interest rate contracts:  |                        |                  |                      |                        |                  |                      |
| Swaps-Cash flow Hedge-Financial institution counterparties      | \$270,000              | \$ 6,408         | \$ 1,243             | \$270,000              | \$ 9,388         | \$ 457               |
| Swaps-Fair Value Hedge-Financial institution counterparties     | —                      | —                | —                    | 21,100                 | —                | 657                  |
| Derivatives designated as non-hedging instruments               |                        |                  |                      |                        |                  |                      |
| Interest rate contracts:  |                        |                  |                      |                        |                  |                      |
| Swaps-Financial institution counterparties                      | 114,348                | 75               | 3,180                | 93,967                 | 1,119            | 1,087                |
| Swaps-Customer counterparties                                   | 93,248                 | 2,244            | 75                   | 93,967                 | 1,087            | 1,119                |
| Gross derivatives   |                        | 8,727            | 4,498                |                        | 11,594           | 3,320                |
| Offsetting derivative assets/liabilities                        |                        | (2,254 )         | (2,254 )             |                        | (2,201 )         | (2,201 )             |
| Cash collateral received/posted                                 |                        | (3,350 )         | (2,169 )             |                        | (8,306 )         | —                    |
| Net derivatives included in the consolidated balance sheets (2) |                        | \$ 3,123         | \$ 75                |                        | \$ 1,087         | \$ 1,119             |

(1) 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.

(2) 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 \$1.4 million credit exposure related to interest rate swaps with financial institutions and \$2.2 million related to interest rate swaps with customers at March 31, 2019. We had no credit exposure related to interest rate swaps with financial institutions and \$1.1 million related to interest rate swaps with customers at December 31, 2018. The credit risk associated with customer transactions is partially mitigated as these are generally secured by the non-cash collateral securing the underlying transaction being hedged.

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 March 31, 2019 and December 31, 2018:

March 31, 2019

December 31, 2018

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|   | Notional<br>Amount | Weighted Average<br>Remaining<br>Maturity<br>(in years) | Receive<br>Rate | Pay<br>Rate | Notional<br>Amount | Weighted Average<br>Remaining<br>Maturity<br>(in years) | Receive<br>Rate | Pay<br>Rate |
|---|--------------------|---|-----------------|-------------|--------------------|---|-----------------|-------------|
| Swaps-Cash flow hedge<br>Financial institution<br>counterparties  | \$270,000          | 4.6   | 2.54 %          | 1.58 %      | \$270,000          | 4.8   | 2.45 %          | 1.58 %      |
| Swaps-Fair value hedge<br>Financial institution<br>counterparties | —                  | —   | —               | —           | 21,100             | 7.5   | 2.56            | 3.00        |
| Swaps-Non-hedging<br>Financial institution<br>counterparties      | 114,348            | 10.6  | 2.53            | 2.65        | 93,967             | 11.6  | 2.36            | 2.58        |
| Customer counterparties   | 93,248             | 11.4  | 2.58            | 2.49        | 93,967             | 11.6  | 2.58            | 2.36        |

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## 11. Fair Value Measurement

Fair value is the price that would be received upon the sale of an asset or paid to transfer a liability (exit price) 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 March 31, 2019 and December 31, 2018 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 three months ended March 31, 2019 or the year ended December 31, 2018.

Securities Available for Sale and Equity Investments with readily determinable fair values – U.S. Treasury securities and equity investments 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 and obtain an understanding of the pricing methodologies used by these 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, as stated in the pricing methodologies of the independent pricing services.

We review and validate the prices supplied by the independent pricing services for reasonableness by comparison to prices obtained from, in most cases, two additional third party sources. For securities where prices are outside a reasonable range, we

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further review those securities, based on internal ALCO approved procedures, to determine what a reasonable fair value measurement is for those securities, 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 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.

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 March 31, 2019 and December 31, 2018.

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 March 31, 2019 and December 31, 2018, the impact of loans with specific reserves based on the fair value of the collateral was reflected in our allowance for loan losses.



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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):

March 31, 2019

| 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                  | \$453,271  | \$—   | \$453,271                                 | \$ —      |
| Other stocks and bonds                            | 2,921  | —   | 2,921                                     | —         |
| Mortgage-backed securities: <sup>(1)</sup>        |  |   |   |           |
| Residential                                       | 1,003,702  | —   | 1,003,702                                 | —         |
| Commercial  | 416,361  | —   | 416,361                                   | —         |
| Equity investments:                               |  |   |   |           |
| Equity investments                                | 5,864  | 5,864   | —   | —         |
| Derivative assets:                                |  |   |   |           |
| Interest rate swaps                               | 8,727  | —   | 8,727                                     | —         |
| Total asset recurring fair value measurements     | \$ 1,890,846   | \$ 5,864                                      | \$ 1,884,982                              | \$ —      |
| Derivative liabilities:                           |  |   |   |           |
| Interest rate swaps                               | \$4,498  | \$—   | \$4,498                                   | \$ —      |
| Total liability recurring fair value measurements | \$4,498  | \$—   | \$4,498                                   | \$ —      |
| Nonrecurring fair value measurements              |  |   |   |           |
| Foreclosed assets                                 | \$ 1,003   | \$—   | \$—                                       | \$ 1,003  |
| Impaired loans <sup>(2)</sup>                     | 31,680   | —   | —   | 31,680    |
| Total asset nonrecurring fair value measurements  | \$32,683   | \$—   | \$—                                       | \$ 32,683 |

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|   | December 31, 2018  |   |  |           |
|---|--|---|--|-----------|
|   | Fair Value Measurements at the<br>End of the Reporting Period Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) |   |  |           |
|   | Carrying<br>Amount   | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |           |
| Recurring fair value measurements                 |  |   |  |           |
| Investment securities:                            |  |   |  |           |
| State and political subdivisions                  | \$716,601  | \$—   | \$716,601  | \$ —      |
| Other stocks and bonds                            | 2,709  | —   | 2,709  | —         |
| Mortgage-backed securities: <sup>(1)</sup>        |  |   |  |           |
| Residential                                       | 732,972  | —   | 732,972  | —         |
| Commercial  | 537,154  | —   | 537,154  | —         |
| Equity investments:                               |  |   |  |           |
| Equity investments                                | 5,791  | 5,791   | —  | —         |
| Derivative assets:                                |  |   |  |           |
| Interest rate swaps                               | 11,594   | —   | 11,594   | —         |
| Total asset recurring fair value measurements     | \$2,006,821  | \$5,791   | \$2,001,030  | \$ —      |
| Derivative liabilities:                           |  |   |  |           |
| Interest rate swaps                               | \$3,320  | \$—   | \$3,320  | \$ —      |
| Total liability recurring fair value measurements | \$3,320  | \$—   | \$3,320  | \$ —      |
| Nonrecurring fair value measurements              |  |   |  |           |
| Foreclosed assets                                 | \$1,206  | \$—   | \$—  | \$ 1,206  |
| Impaired loans <sup>(2)</sup>                     | 37,813   | —   | —  | 37,813    |
| Total asset nonrecurring fair value measurements  | \$39,019   | \$—   | \$—  | \$ 39,019 |

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

Equity investments - Equity investments with readily determinable fair values are presented at fair value based upon the currently available bid-and-ask quotations publicly available on a market or exchange. The carrying value of other equity investments without readily determinable fair values are measured at cost less impairment, if any, adjusted for observable price changes for an identical or similar investment of the same issuer. This carrying value is a reasonable estimate of the fair value of those assets.

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Loans receivable - We estimate the fair value of our loan portfolio to an exit price notion with adjustments for liquidity, credit and prepayment factors. 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.

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 borrowings - The fair value of these borrowings is estimated by discounting the future cash flows using rates at which borrowings 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.

Trust preferred subordinated debentures - 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 and financial liabilities measured on a nonrecurring basis at both their respective carrying amounts and estimated fair value (in thousands):

| March 31, 2019  | Carrying Amount | Estimated Fair Value |           |             |           |
|---|-----------------|----------------------|-----------|-------------|-----------|
|   |                 | Total                | Level 1   | Level 2     | Level 3   |
| Financial assets:   |                 |                      |           |             |           |
| Cash and cash equivalents   | \$269,943       | \$269,943            | \$269,943 | \$—         | \$ —      |
| Investment securities:  |                 |                      |           |             |           |
| Held to maturity, at carrying value   | 3,025           | 3,054                | —         | 3,054       | —         |
| Mortgage-backed securities:   |                 |                      |           |             |           |
| Held to maturity, at carrying value   | 144,406         | 144,612              | —         | 144,612     | —         |
| FHLB stock, at cost   | 35,269          | 35,269               | —         | 35,269      | —         |
| Equity investments  | 6,318           | 6,318                | —         | 6,318       | —         |
| Loans, net of allowance for loan losses   | 3,280,955       | 3,293,896            | —         | —           | 3,293,896 |
| Loans held for sale   | 384             | 384                  | —         | 384         | —         |
| Financial liabilities:  |                 |                      |           |             |           |
| Deposits  | \$4,567,893     | \$4,563,629          | \$—       | \$4,563,629 | \$ —      |
| Federal funds purchased and repurchase agreements                               | 8,637           | 8,637                | —         | 8,637       | —         |
| FHLB borrowings   | 619,861         | 614,247              | —         | 614,247     | —         |
| Subordinated notes, net of unamortized debt issuance costs                      | 98,448          | 98,400               | —         | 98,400      | —         |
| Trust preferred subordinated debentures, net of unamortized debt issuance costs | 60,247          | 57,637               | —         | 57,637      | —         |

  

| December 31, 2018   | Carrying Amount | Estimated Fair Value |           |             |           |
|---|-----------------|----------------------|-----------|-------------|-----------|
|   |                 | Total                | Level 1   | Level 2     | Level 3   |
| Financial assets:   |                 |                      |           |             |           |
| Cash and cash equivalents   | \$120,719       | \$120,719            | \$120,719 | \$—         | \$ —      |
| Investment securities:  |                 |                      |           |             |           |
| Held to maturity, at carrying value   | 3,083           | 3,046                | —         | 3,046       | —         |
| Mortgage-backed securities:   |                 |                      |           |             |           |
| Held to maturity, at carrying value   | 159,848         | 156,735              | —         | 156,735     | —         |
| FHLB stock, at cost   | 32,583          | 32,583               | —         | 32,583      | —         |
| Equity investments  | 6,302           | 6,302                | —         | 6,302       | —         |
| Loans, net of allowance for loan losses   | 3,285,780       | 3,251,923            | —         | —           | 3,251,923 |
| Loans held for sale   | 601             | 601                  | —         | 601         | —         |
| Financial liabilities:  |                 |                      |           |             |           |
| Deposits  | \$4,425,030     | \$4,417,902          | \$—       | \$4,417,902 | \$ —      |
| Federal funds purchased and repurchase agreements                               | 36,810          | 36,810               | —         | 36,810      | —         |
| FHLB borrowings   | 719,065         | 708,904              | —         | 708,904     | —         |
| Subordinated notes, net of unamortized debt issuance costs                      | 98,407          | 97,611               | —         | 97,611      | —         |
| Trust preferred subordinated debentures, net of unamortized debt issuance costs | 60,246          | 54,729               | —         | 54,729      | —         |

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

## 12. Income Taxes

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

|                                       | Three Months<br>Ended<br>March 31, |         |
|---------------------------------------|------------------------------------|---------|
|                                       | 2019                               | 2018    |
| Current income tax expense            | \$3,011                            | \$2,345 |
| Deferred income tax expense (benefit) | 126                                | (255 )  |
| Income tax expense                    | \$3,137                            | \$2,090 |

Net deferred tax assets totaled \$491,000 at March 31, 2019 and \$9.8 million at December 31, 2018. No valuation allowance for the net deferred tax asset was recorded at March 31, 2019 or December 31, 2018, as management believes it is more likely than not that all of the net deferred tax asset will be realized in future years. Unrecognized tax benefits were not material at March 31, 2019 or December 31, 2018.

We recognized income tax expense of \$3.1 million, for an effective tax rate ("ETR") of 14.3% for the three months ended March 31, 2019, compared to income tax expense of \$2.1 million, for an ETR of 11.4%, for the three months ended March 31, 2018. The higher ETR for the three months ended March 31, 2019 was mainly due to a decrease in tax-exempt income as a percentage of pre-tax income as compared to the same period in 2018. The ETR differs from the stated rate of 21% for the three months ended March 31, 2019 and 2018 primarily due to the effect of tax-exempt income from municipal loans and securities, as well as bank owned life insurance. We file income tax returns in the U.S. federal jurisdictions and in certain states. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2015 or Texas state tax examinations by tax authorities for years before 2014.

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## 13. Leases

We lease certain retail- and full-service branch locations, ATM locations, certain equipment and a loan production office. Leases with an initial term of twelve months or less are not recorded on the balance sheet. Operating lease cost, which is comprised of the amortization of the ROU asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term and is included in net occupancy expense on our consolidated statements of income. We evaluate the lease term by assuming the exercise of options to extend that are reasonably assured and those option periods covered by an option to terminate the lease, if deemed not reasonably certain to be exercised. The lease term is used to determine the straight-line expense and limits the depreciable life of any related leasehold improvements. Certain leases require us to pay real estate taxes, insurance, maintenance and other operating expenses associated with the leased premises. These expenses are classified in net occupancy expense on our consolidated statements of income, consistent with similar costs for owned locations, but is not included in operating lease cost below.

Our leases have remaining lease terms ranging from 7 months to 20.1 years, some of which include options to extend the leases for up to 10 years, and some of which include options to terminate the leases within 2 years. We calculate the lease liability using a discount rate that represents our incremental borrowing rate at the lease commencement date.

We are also party to operating leases where we lease properties we own to third parties. Operating lease income received from tenants who rent our properties is reported as a reduction to occupancy expense on our consolidated statements of income. The underlying assets associated with these operating leases are included in premises and equipment on our consolidated balance sheets.

Balance sheet information related to leases was as follows (in thousands):

|                                     |                   |
|-------------------------------------|-------------------|
|                                     | March 31,<br>2019 |
| Operating leases:                   |                   |
| Operating lease right-of-use assets | \$ 9,455          |
| Operating lease liabilities         | \$ 9,811          |

The components of lease cost were as follows (in thousands):

|  |                      |        |
|--|----------------------|--------|
| Three<br>Months<br>Ended<br>March<br>31,<br>2019 | Operating lease cost | \$ 394 |
|--|----------------------|--------|

Supplemental cash flow information related to leases was as follows (in thousands):

|  |   |        |
|--|---|--------|
| Three<br>Months<br>Ended<br>March<br>31,<br>2019 | Cash paid for amounts included in the measurement of the lease liabilities: |        |
|  | Operating cash flows from operating leases                                  | \$ 340 |

Right-of-use assets obtained in exchange for new operating lease liabilities \$ —

Additional information related to leases was as follows:

|  | March 31,<br>2019 |
|--|-------------------|
| Weighted average remaining lease term (in years) | 12.3              |
| Weighted average discount rate                   | 3.91 %            |



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Future minimum rental commitments due under non-cancelable operating leases at March 31, 2019 were as follows (in thousands):

|  |          |
|--|----------|
| Year ending December 31,                               |          |
| 2019 (excluding the three months ended March 31, 2019) | \$977    |
| 2020   | 1,287    |
| 2021   | 1,180    |
| 2022   | 1,142    |
| 2023   | 992      |
| 2024 and thereafter                                    | 7,219    |
| Total lease payments                                   | 12,797   |
| Less: Interest   | (2,986 ) |
| Present value of lease liabilities                     | \$9,811  |

We also lease certain of our owned facilities or portions thereof to third parties. Our primary leased facility is a 202,000 square-foot office building in Fort Worth, Texas that is used for a branch location and certain bank operations. We occupy approximately 41,000 square feet of the building and lease the remaining space to various tenants. Some of these leases contain options to renew and options to terminate at the discretion of the tenant.

Gross rental income from these leases were as follows (in thousands):

|                     |        |
|---------------------|--------|
| Three               |        |
| Months              |        |
| Ended               |        |
| March               |        |
| 31,                 |        |
| 2019                |        |
| Gross rental income | \$ 745 |

At March 31, 2019, non-cancelable operating leases with future minimum lease payments are as follows (in thousands):

|  |          |
|--|----------|
| Year ending December 31,                               |          |
| 2019 (excluding the three months ended March 31, 2019) | \$2,050  |
| 2020   | 2,572    |
| 2021   | 1,487    |
| 2022   | 1,466    |
| 2023   | 1,227    |
| 2024 and thereafter                                    | 4,048    |
| Total lease payments                                   | \$12,850 |

#### 14. 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.

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

|                              | March 31, December 31, |            |
|------------------------------|------------------------|------------|
|                              | 2019                   | 2018       |
| Unused commitments:          |                        |            |
| Commitments to extend credit | \$900,422              | \$ 874,557 |
| Standby letters of credit    | 26,826                 | 27,438     |
| Total                        | \$927,248              | \$ 901,995 |

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.

Securities. In the normal course of business we buy and sell securities. At March 31, 2019, there were \$55.8 million of unsettled trades to purchase securities and \$95.5 million unsettled trades to sell securities. At December 31, 2018, there were \$6.4 million unsettled trades to purchase securities and no unsettled trades to sell securities.

Deposits. There were no unsettled issuances of brokered certificates of deposits ("CD") at March 31, 2019. There were \$15.2 million unsettled issuances of brokered CDs at December 31, 2018.

Litigation. We are involved with 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, 2018.

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,” “might,” “will,” “seek,” “intend,” “probability,” “risk,” “goal,” “target,” “objective,” “plans,” “potential,” and similar expressions. Forward-looking statements are statements with respect to our beliefs, plans, expectations, objectives, goals, anticipations, assumptions, estimates, intentions and 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 of the effect of our expansion, trends in asset quality and earnings from growth, and certain market risk disclosures 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;
- technological changes, including potential cyber-security incidents;
- our ability to identify and address cyber-security risks such as data security breaches, malware, “denial of service” attacks, “hacking” and identity theft, a failure of which could disrupt our business and result in the disclosure of and/or misuse or misappropriation of confidential or proprietary information, disruption or damage of our systems, increased costs, significant losses, or adverse effects to our reputation;
- the risk that our enterprise risk management framework may not identify or address risks adequately, which may result in unexpected losses;
- 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 failure to maintain an effective system of controls and procedures, including internal control over financial reporting;
- 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;

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• 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;

• risks related to fluctuations in 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;

• execution of future acquisitions, 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, 2018.

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. We consider accounting estimates that can (1) be replaced by other reasonable estimates and/or (2) changes to an estimate from period to period that have a material impact on the presentation of our financial condition, changes in financial condition or results of operations as well as (3) those estimates that require significant and complex assumptions about matters that are highly uncertain to be critical accounting estimates. We consider our critical accounting policies to include allowance for losses on loans, estimation of fair value, business combination and pension plan accounting.

Critical accounting estimates include a high degree of uncertainty in the underlying assumptions. Management bases its estimates on historical experience, current information and other factors deemed relevant. The development, selection and disclosure of our critical accounting estimates are reviewed with the Audit Committee of the Company's Board of Directors. Actual results could differ from these estimates. For additional information regarding critical accounting policies, refer to “Note 1 - Summary of Significant Accounting Policies” and “Note 6 - Loans and Allowance for Probable Loan Losses” in the notes to consolidated financial statements and refer to “Part II - Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Estimates,” and “Note 1 - Summary of Significant Accounting and Reporting Policies” in our Annual Report on Form 10-K for the year ended December 31, 2018. As of the date of this report, there have been no significant changes to our critical accounting estimates.



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## 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 (“FTE”): Net interest income (FTE), Net interest margin (FTE) and Net interest spread (FTE), which include the effects of taxable-equivalent adjustments using a federal income tax rate of 21% for the three months ended March 31, 2019 and 2018, to increase tax-exempt interest income to a tax-equivalent basis. Interest income earned on certain assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than taxable investments.

Net interest income (FTE), Net interest margin (FTE) and Net interest spread (FTE). Net interest income (FTE) is a non-GAAP measure that adjusts for the tax-favored status of net interest income from certain loans and investments and is not permitted under GAAP in the consolidated statements of income. 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 (FTE) is the ratio of net interest income (FTE) to average earning assets. The most directly comparable financial measure calculated in accordance with GAAP is our net interest margin. Net interest spread (FTE) is the difference in the average yield on average 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 alternatives to GAAP-basis financial statements, and other bank holding companies may define or calculate these non-GAAP measures or similar measures differently. 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.

In the following table we present the reconciliation of net interest income to net interest income adjusted to a fully taxable-equivalent basis assuming a 21% marginal tax rate for the three months ended March 31, 2019 and 2018, for interest earned on tax-exempt assets such as municipal loans and investment securities (dollars in thousands), along with the calculation of net interest margin (FTE) and net interest spread (FTE).

## Non-GAAP Reconciliations

|  | Three Months Ended |             |   |
|--|--------------------|-------------|---|
|  | March 31,          |             |   |
|  | 2019               | 2018        |   |
| Net interest income (GAAP)               | \$41,125           | \$44,133    |   |
| Tax equivalent adjustments:              |                    |             |   |
| Loans                                    | 598                | 582         |   |
| Investment securities (tax-exempt)       | 1,614              | 1,619       |   |
| Net interest income (FTE) <sup>(1)</sup> | \$43,337           | \$46,334    |   |
| <br>                                     |                    |             |   |
| Average earning assets                   | \$5,733,116        | \$5,891,352 |   |
| <br>                                     |                    |             |   |
| Net interest margin                      | 2.91               | % 3.04      | % |
| Net interest margin (FTE) <sup>(1)</sup> | 3.07               | % 3.19      | % |
| <br>                                     |                    |             |   |
| Net interest spread                      | 2.56               | % 2.80      | % |
| Net interest spread (FTE) <sup>(1)</sup> | 2.71               | % 2.95      | % |

(1) These amounts are presented on a fully taxable-equivalent basis and are non-GAAP measures.



Management believes adjusting net interest income, net interest margin and net interest spread to a fully taxable-equivalent basis is a standard practice in the banking industry as these measures provide useful information to make peer comparisons. Tax-equivalent adjustments are reported in the respective earning asset categories as listed in the “Average Balances with Average Yields and Rates” tables under Results of Operations.

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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):

|                              | March 31, December 31, |            |
|------------------------------|------------------------|------------|
|                              | 2019                   | 2018       |
| Unused commitments:          |                        |            |
| Commitments to extend credit | \$900,422              | \$ 874,557 |
| Standby letters of credit    | 26,826                 | 27,438     |
| Total                        | \$927,248              | \$ 901,995 |

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.

Securities. In the normal course of business we buy and sell securities. At March 31, 2019, there were \$55.8 million of unsettled trades to purchase securities and \$95.5 million unsettled trades to sell securities. At December 31, 2018, there were \$6.4 million unsettled trades to purchase securities and no unsettled trades to sell securities.

Deposits. There were no unsettled issuances of brokered certificates of deposits ("CD") at March 31, 2019. There were \$15.2 million unsettled issuances of brokered CDs at December 31, 2018.

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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## OVERVIEW

## Operating Results

During the three months ended March 31, 2019, our net income increased \$2.6 million, or 15.8%, to \$18.8 million from \$16.3 million for the same period in 2018. The increase in net income was largely driven by the \$4.7 million decrease in provision for loan losses and \$2.0 million decrease in noninterest expense, as well as, a \$1.8 million increase in interest income, partially offset by a \$4.8 million increase in interest expense and a \$1.0 million increase in income tax expense. Earnings per diluted common share increased \$0.10, or 21.7% to \$0.56 for the three months ended March 31, 2019, from \$0.46 for the same period in 2018.

## Financial Condition

Our total assets increased \$93.7 million, or 1.5%, to \$6.22 billion at March 31, 2019 from \$6.12 billion at December 31, 2018. Our securities portfolio decreased by \$128.7 million, or 6.0%, to \$2.02 billion, compared to \$2.15 billion at December 31, 2018 primarily due to sales of lower yielding AFS securities. Our FHLB stock increased \$2.7 million, or 8.2%, to \$35.3 million from \$32.6 million at December 31, 2018 primarily due to increases in the amount of FHLB stock we were required to hold throughout the quarter that was not immediately repurchased by the FHLB as our FHLB borrowings declined. Our interest earning deposits increased \$160.7 million, or 673.0%, to \$184.6 million at March 31, 2019, compared to \$23.9 million at December 31, 2018, a direct result of securities sold in March 2019 that were not yet reinvested.

Loans decreased \$7.7 million, or 0.2%, to \$3.31 billion compared to December 31, 2018. The net decrease in our loan portfolio was comprised of decreases of \$89.7 million of commercial real estate loans, \$10.3 million of municipal loans, \$8.3 million of 1-4 family residential loans and \$6.3 million of loans to individuals, partially offset by increases of \$95.7 million of construction loans and \$11.3 million of commercial loans.

Our nonperforming assets at March 31, 2019 decreased 11.2%, to \$38.1 million and represented 0.61% of total assets, compared to \$42.9 million, or 0.70% of total assets at December 31, 2018. Nonaccruing loans decreased \$18.1 million, or 50.5%, to \$17.7 million, and the ratio of nonaccruing loans to total loans decreased to 0.54% at March 31, 2019 compared to 1.08% at December 31, 2018. The decrease in nonaccrual loans was primarily the result of the sale of three commercial real estate loans of approximately \$16.7 million. Our accruing loans past due more than 90 days increased \$7.9 million consisting of one commercial real estate loan that paid off in full on April 15, 2019. Restructured loans were \$11.5 million at March 31, 2019, an increase of 93.8%, from \$5.9 million at December 31, 2018 due to the renegotiation of a commercial real estate loan. Other Real Estate Owned ("OREO") decreased to \$978,000 at March 31, 2019 from \$1.2 million at December 31, 2018.

Our deposits increased \$142.9 million, or 3.2%, to \$4.57 billion at March 31, 2019 from \$4.43 billion at December 31, 2018, which was comprised of an increase of \$99.4 million in interest bearing deposits and an increase of \$43.4 million in noninterest bearing deposits. The increase in our deposits during 2019 was the result of an increase in private deposits of \$194.3 million, partially offset by a decrease in public fund deposits of \$51.4 million. Brokered deposits, included in our private deposits, increased \$130.0 million, or 53.5%, for the three months ended March 31, 2019.

Total FHLB borrowings decreased \$99.2 million, or 13.8%, to \$619.9 million at March 31, 2019 from \$719.1 million at December 31, 2018, while our brokered deposits increased \$130.0 million, or 53.5%, to \$373.1 million at March 31, 2019 from \$243.1 million at December 31, 2018, as we adjusted our overall interest rate risk objectives in response to the decreases in our securities portfolio and the rising interest rate market.

The increase in shareholders' equity was the result of a decrease in accumulated other comprehensive loss of \$34.5 million, net income of \$18.8 million, stock compensation expense of \$661,000, common stock issued under our dividend reinvestment plan of \$355,000 and net issuance of common stock under employee stock plans of \$338,000, partially offset by a reduction to retained earnings of \$16.5 million for a cumulative-effect adjustment related to the adoption of ASU 2017-08, as well as cash dividends paid of \$10.1 million and the repurchase of \$1.3 million of our common stock.

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.

Table of Contents**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 or the brokered CD market. 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 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, 2018, for a discussion of risks related to interest rates. 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 Asset/Liability (“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 relatively low interest rate environment 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 appropriate or 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.

Our investment securities and U.S. Agency MBS decreased from \$2.15 billion at December 31, 2018 to \$2.02 billion at March 31, 2019. The decrease was due to the realignment of the securities portfolio during the quarter to meet our balance sheet strategy and ALCO objectives.

During the three months ended March 31, 2019, we sold over \$520.0 million of AFS securities that resulted in a net realized gain of \$256,000. We sold Texas municipal securities and U.S. Government Agency MBS. The sales of lower yielding fixed rate securities were to help alleviate margin compression brought on by the flattening yield curve. During the three months ended March 31, 2019, sales of securities were partially offset by purchases of U.S. Agency MBS and primarily Texas municipal securities with higher yields.

At March 31, 2019, securities as a percentage of assets decreased to 32.5%, as compared to 35.1% at December 31, 2018 due primarily to the \$128.7 million, or 6.0%, decrease in the securities portfolio. 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.

With respect to liabilities, we continue to utilize a combination of FHLB borrowings 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.

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Our FHLB borrowings decreased 13.8%, or \$99.2 million, to \$619.9 million at March 31, 2019 from \$719.1 million at December 31, 2018. Southside Bank has entered into various variable rate advance agreements with the FHLB. These advance agreements totaled \$310.0 million at both March 31, 2019 and December 31, 2018. Three of the variable rate advance agreements have interest rates tied to three-month LIBOR and the remaining agreements have interest rates tied to one-month LIBOR. In connection with \$270.0 million of these variable rate advance agreements, Southside Bank also entered into various interest rate swap contracts that are treated as cash flow hedges under ASC Topic 815, “Derivatives and Hedging” that effectively convert the variable rate advance agreements to fixed interest rates that average 1.58% with an average weighted maturity of 4.6 years at March 31, 2019. The remaining \$40.0 million of variable rate advance agreements have interest rates that closely approximate one-month LIBOR. 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.

Our brokered CDs increased 54.6% from \$238.1 million at December 31, 2018 to \$368.1 million at March 31, 2019, due to lower funding costs currently offered compared to other wholesale funding alternatives and ALCO objectives. At March 31, 2019, our brokered CDs had a weighted average cost of 231 basis points and remaining maturities of less than ten months. Our wholesale funding policy currently allows maximum brokered deposits of \$400.0 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 three months ended March 31, 2019, the increase in brokered CDs, resulted in an increase in our total wholesale funding as a percentage of deposits, not including brokered deposits, to 23.7% at March 31, 2019 from 23.0% at December 31, 2018, partially offset by the decrease in FHLB borrowings.

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## 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.

The following table presents net interest income for the periods presented (in thousands):

|   | Three Months<br>Ended<br>March 31, |          |
|---|------------------------------------|----------|
|   | 2019                               | 2018     |
| Interest income:                        |                                    |          |
| Loans                                   | \$41,619                           | \$38,830 |
| Investment securities – taxable         | 28                                 | 227      |
| Investment securities – tax-exempt      | 4,118                              | 6,381    |
| Mortgage-backed securities              | 12,474                             | 10,894   |
| FHLB stock and other investments        | 355                                | 414      |
| Other interest earning assets           | 433                                | 448      |
| Total interest income                   | 59,027                             | 57,194   |
| Interest expense:                       |                                    |          |
| Deposits                                | 11,241                             | 7,451    |
| FHLB borrowings                         | 4,457                              | 3,632    |
| Subordinated notes                      | 1,400                              | 1,398    |
| Trust preferred subordinated debentures | 729                                | 569      |
| Other borrowings                        | 75                                 | 11       |
| Total interest expense                  | 17,902                             | 13,061   |
| Net interest income                     | \$41,125                           | \$44,133 |

## 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. During the first quarter of 2018, the Federal Reserve increased the federal funds rate by 25 basis points and an additional 75 basis points through the remainder of 2018. These increases in short term interest rates have contributed to net interest margin compression.

Net interest income for the three months ended March 31, 2019 decreased \$3.0 million, or 6.8%, to \$41.1 million, compared to \$44.1 million for the same period in 2018. The decrease in net interest income for the three months ended March 31, 2019, compared to the same period in 2018, was the result of the increase in interest expense primarily from our deposits and FHLB borrowings, partially offset by an increase in interest income primarily from our loan portfolio. Total interest expense increased \$4.8 million, or 37.1%, to \$17.9 million during the three months ended March 31, 2019, compared to \$13.1 million during the same period in 2018. Total interest income increased \$1.8



million, or 3.2%, to \$59.0 million during the three months ended March 31, 2019, compared to \$57.2 million during the same period in 2018. Our net interest margin (FTE) decreased to 3.07% for the three months ended March 31, 2019, compared to 3.19% for the same period in 2018 and our net interest spread (FTE) decreased to 2.71%, compared to 2.95% for the same period in 2018.

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

The following table presents on a fully taxable-equivalent basis, a non-GAAP measure, the net change in net interest income and sets forth the dollar amount of increase (decrease) in the average volume of interest earning assets and interest bearing liabilities and from changes in yields/rates. 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 (in thousands):

| Fully Taxable-Equivalent Basis:   | Three Months Ended March 31, 2019 Compared to 2018 |                    |              |
|---|--|--------------------|--------------|
|   | Change Attributable to Average Volume              | Average Yield/Rate | Total Change |
| Interest income on:   |  |                    |              |
| Loans <sup>(1)</sup>  | \$(46 )  | \$ 2,855           | \$2,809      |
| Loans held for sale   | (9 )   | 5                  | (4 )         |
| Investment securities (taxable)   | (287 )   | 88                 | (199 )       |
| Investment securities (tax-exempt) <sup>(1)</sup>                               | (1,343)  | (925 )             | (2,268 )     |
| Mortgage-backed securities  | 654  | 926                | 1,580        |
| FHLB stock, at cost, and equity investments                                     | (86 )  | 27                 | (59 )        |
| Interest earning deposits   | (197 )   | 184                | (13 )        |
| Federal funds sold  | (26 )  | 24                 | (2 )         |
| Total earning assets  | (1,340)  | 3,184              | 1,844        |
| Interest expense on:  |  |                    |              |
| Savings deposits  | 4  | 70                 | 74           |
| Time deposits   | (53 )  | 1,855              | 1,802        |
| Interest bearing demand deposits  | (45 )  | 1,959              | 1,914        |
| FHLB borrowings   | (480 )   | 1,305              | 825          |
| Subordinated notes, net of unamortized debt issuance costs                      | 2  | —                  | 2            |
| Trust preferred subordinated debentures, net of unamortized debt issuance costs | —  | 160                | 160          |
| Other borrowings  | 20   | 44                 | 64           |
| Total interest bearing liabilities  | (552 )   | 5,393              | 4,841        |
| Net change  | \$(788)  | \$(2,209 )         | \$(2,997)    |

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

The increase in total interest income was primarily attributable to the increase in the average yield on earning assets to 4.33% for the three months ended March 31, 2019 from 4.09% for the three months ended March 31, 2018, partially offset by the decrease in average earning assets of \$158.2 million, or 2.7%, to \$5.73 billion for the three months ended March 31, 2019, from \$5.89 billion for the same period in 2018. The increase in the average yield on total earning assets during the three months ended March 31, 2019 was primarily due to rising interest rates due to continued increases in the federal funds rate during 2018. The decrease in average earning assets was primarily the result of the decreases in average securities and average interest earning deposits during 2019.

The increase in total interest expense for the three months ended March 31, 2019 was primarily attributable to the increase in the average rates paid on total interest bearing liabilities to 1.62% for the three months ended March 31, 2019 from 1.14% for the three months ended March 31, 2018, slightly offset by the decrease in average interest bearing liabilities of \$138.6 million, or 3.0%, to \$4.49 billion during the three months ended March 31, 2019 from \$4.63 billion during the three months ended March 31, 2018. The increase in average rates paid on interest bearing liabilities was primarily due to the increases in the federal fund rate during 2018. The decrease in average interest-bearing liabilities was primarily the result of the decrease in average FHLB borrowings.



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The “Average Balances with Average Yields and Rates” table that follows shows average earning assets and interest bearing liabilities together with the average yield on the earning assets and the average rate of the interest bearing liabilities (dollars in thousands) for the three months ended March 31, 2019 and 2018. The interest and related yields presented are on a fully taxable-equivalent (“FTE”) basis and are therefore non-GAAP measures. See “Non-GAAP Financial Measures” for more information, and for a reconciliation to GAAP.

|   | Average Balances with Average Yields and Rates (Annualized)<br>(unaudited) |          |                   |   |                |          |                   |   |
|---|--|----------|-------------------|---|----------------|----------|-------------------|---|
|   | Three Months Ended<br>March 31, 2019                                       |          |                   |   | March 31, 2018 |          |                   |   |
|   | Avg<br>Balance   | Interest | Avg<br>Yield/Rate |   | Avg<br>Balance | Interest | Avg<br>Yield/Rate |   |
| <b>ASSETS</b>   |  |          |                   |   |                |          |                   |   |
| Loans <sup>(1)</sup>  | \$3,296,665  | \$42,210 | 5.19              | % | \$3,300,506    | \$39,401 | 4.84              | % |
| Loans held for sale   | 611  | 7        | 4.65              | % | 1,543          | 11       | 2.89              | % |
| Securities:   |  |          |                   |   |                |          |                   |   |
| Investment securities (taxable) <sup>(2)</sup>                                  | 3,000  | 28       | 3.79              | % | 39,332         | 227      | 2.34              | % |
| Investment securities (tax-exempt) <sup>(2)</sup>                               | 659,187  | 5,732    | 3.53              | % | 805,091        | 8,000    | 4.03              | % |
| Mortgage-backed and related securities <sup>(2)</sup>                           | 1,647,564  | 12,474   | 3.07              | % | 1,557,140      | 10,894   | 2.84              | % |
| Total securities  | 2,309,751  | 18,234   | 3.20              | % | 2,401,563      | 19,121   | 3.23              | % |
| FHLB stock, at cost, and equity investments                                     | 53,764   | 355      | 2.68              | % | 67,000         | 414      | 2.51              | % |
| Interest earning deposits   | 64,690   | 386      | 2.42              | % | 107,488        | 399      | 1.51              | % |
| Federal funds sold  | 7,635  | 47       | 2.50              | % | 13,252         | 49       | 1.50              | % |
| Total earning assets  | 5,733,116  | 61,239   | 4.33              | % | 5,891,352      | 59,395   | 4.09              | % |
| Cash and due from banks   | 83,147   |          |                   |   | 78,031         |          |                   |   |
| Accrued interest and other assets   | 513,738  |          |                   |   | 493,974        |          |                   |   |
| Less: Allowance for loan losses   | (27,060 )  |          |                   |   | (21,005 )      |          |                   |   |
| Total assets  | \$6,302,941  |          |                   |   | \$6,442,352    |          |                   |   |
| <b>LIABILITIES AND SHAREHOLDERS’ EQUITY</b>                                     |  |          |                   |   |                |          |                   |   |
| Savings deposits  | \$360,664  | 258      | 0.29              | % | \$353,770      | 184      | 0.21              | % |
| Time deposits   | 1,154,203  | 5,697    | 2.00              | % | 1,170,024      | 3,895    | 1.35              | % |
| Interest bearing demand deposits  | 1,982,891  | 5,286    | 1.08              | % | 2,009,154      | 3,372    | 0.68              | % |
| Total interest bearing deposits   | 3,497,758  | 11,241   | 1.30              | % | 3,532,948      | 7,451    | 0.86              | % |
| FHLB borrowings   | 816,389  | 4,457    | 2.21              | % | 928,677        | 3,632    | 1.59              | % |
| Subordinated notes, net of unamortized debt issuance costs                      | 98,428   | 1,400    | 5.77              | % | 98,267         | 1,398    | 5.77              | % |
| Trust preferred subordinated debentures, net of unamortized debt issuance costs | 60,246   | 729      | 4.91              | % | 60,241         | 569      | 3.83              | % |
| Other borrowings  | 16,788   | 75       | 1.81              | % | 8,103          | 11       | 0.55              | % |
| Total interest bearing liabilities  | 4,489,609  | 17,902   | 1.62              | % | 4,628,236      | 13,061   | 1.14              | % |
| Noninterest bearing deposits  | 986,343  |          |                   |   | 1,016,707      |          |                   |   |
| Accrued expenses and other liabilities  | 89,768   |          |                   |   | 44,015         |          |                   |   |
| Total liabilities   | 5,565,720  |          |                   |   | 5,688,958      |          |                   |   |
| Shareholders’ equity  | 737,221  |          |                   |   | 753,394        |          |                   |   |
| Total liabilities and shareholders’ equity                                      | \$6,302,941  |          |                   |   | \$6,442,352    |          |                   |   |
| Net interest income (FTE)   |  | \$43,337 |                   |   |                | \$46,334 |                   |   |
| Net interest margin (FTE)   |  |          | 3.07              | % |                |          | 3.19              | % |
| Net interest spread (FTE)   |  |          | 2.71              | % |                |          | 2.95              | % |

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

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

Note: As of March 31, 2019 and 2018, loans totaling \$17.7 million and \$34.5 million, 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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## Noninterest Income

Noninterest income consists of revenue generated from a broad range of financial services and activities and other fee generating services that we either provide or in which we participate.

The following table details the categories included in noninterest income (dollars in thousands):

|  | Three Months |         | 2019        |         |
|--|--------------|---------|-------------|---------|
|  | Ended        |         | Change From |         |
|  | March 31,    |         | 2018        |         |
|  | 2019         | 2018    | 2018        |         |
| Deposit services   | \$5,986      | \$6,179 | \$(193)     | (3.1)%  |
| Net gain (loss) on sale of securities available for sale | 256          | (827)   | 1,083       | 131.0%  |
| Gain on sale of loans                                    | 93           | 115     | (22)        | (19.1)% |
| Trust income   | 1,541        | 1,760   | (219)       | (12.4)% |
| Bank owned life insurance income                         | 544          | 632     | (88)        | (13.9)% |
| Brokerage services                                       | 517          | 450     | 67          | 14.9%   |
| Other noninterest income                                 | 601          | 1,301   | (700)       | (53.8)% |
| Total noninterest income                                 | \$9,538      | \$9,610 | \$(72)      | (0.7)%  |

The 0.7% decrease in noninterest income for the three months ended March 31, 2019, when compared to the same period in 2018, was primarily due to decreases in other noninterest income, trust income and deposit services income, partially offset by an increase in net gain on sale of securities available for sale.

The decrease in deposit services income is primarily a result of a decrease in returned check fees, partially offset by increases in net debit card income and overdraft fees.

During the three months ended March 31, 2019, we sold Texas municipal securities and mortgage related securities that resulted in a net gain on sale of AFS securities of \$256,000.

The decrease in gain on sale of loans during the three months ended March 31, 2019, compared to the same period in 2018, was due to a decline in the volume of loans sold.

The decrease in trust income for the three months ended March 31, 2019 was primarily due to the result of the integration of the trust fee billing cycle during the first quarter of 2018 in connection with the Diboll acquisition.

The decrease in bank owned life insurance income during the three months ended March 31, 2019 compared to March 31, 2018 was primarily due to the decrease in the amount of bank owned life insurance held at March 31, 2019.

Brokerage services income increased during the three months ended March 31, 2019, compared to the same period in 2018, due to a general increase in production.

Other noninterest income decreased during the three months ended March 31, 2019 primarily due to a partial loss on a fair value hedge interest rate swap and a decrease in mortgage servicing fee income.

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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 (dollars in thousands):

|                                      | Three Months Ended March 31, |          | 2019 Change From 2018 |          |
|--------------------------------------|------------------------------|----------|-----------------------|----------|
|                                      | 2019                         | 2018     | 2018                  |          |
| Salaries and employee benefits       | \$18,046                     | \$18,559 | \$(513)               | (2.8)%   |
| Net occupancy expense                | 3,175                        | 3,583    | (408)                 | (11.4)%  |
| Acquisition expense                  | —                            | 832      | (832)                 | (100.0)% |
| Advertising, travel & entertainment  | 847                          | 685      | 162                   | 23.6%    |
| ATM expense                          | 180                          | 346      | (166)                 | (48.0)%  |
| Professional fees                    | 1,314                        | 1,070    | 244                   | 22.8%    |
| Software and data processing expense | 1,076                        | 1,023    | 53                    | 5.2%     |
| Telephone and communications         | 487                          | 538      | (51)                  | (9.5)%   |
| FDIC insurance                       | 422                          | 497      | (75)                  | (15.1)%  |
| Amortization expense on intangibles  | 1,179                        | 1,378    | (199)                 | (14.4)%  |
| Other noninterest expense            | 2,901                        | 3,156    | (255)                 | (8.1)%   |
| Total noninterest expense            | \$29,627                     | \$31,667 | \$(2,040)             | (6.4)%   |

The decrease in noninterest expense for the three months ended March 31, 2019, compared to the same period in 2018, was the result of decreases in acquisition expense, salaries and employee benefits expense, net occupancy expense and other noninterest expense.

Salary and employee benefits decreased for the three months ended March 31, 2019, compared to the same period in 2018, due to decreases in direct salary expense and retirement expense, partially offset by an increase in health insurance expense. Direct salary expense decreased \$543,000, or 3.4%, during the three months ended March 31, 2019, compared to the same period in 2018, due to one-time bonus payments in the first quarter of 2018 of \$744,000 to certain employees in response to the benefits received from the Tax Cuts and Jobs Act. The decrease in 2019 was partially offset by normal salary increases effective in the first quarter of 2019.

Retirement expense decreased \$180,000, or 16.9%, for the three months ended March 31, 2019, compared to the same period in 2018, due to decreases in our split dollar agreement expense, defined benefit pension plan expense as well as deferred compensation plan expense. The decrease during the three months ended March 31, 2019 was primarily due to the death of a retired covered officer during the second quarter of 2018 and a decrease in estimated service cost related to net periodic benefit cost of our defined benefit pension plan.

Health and life insurance expense, included in salaries and employee benefits, increased \$210,000, or 14.1%, during the three months ended March 31, 2019, compared to the same period in 2018. We have a self-insured health plan which is supplemented with a stop loss insurance policy. Health insurance costs are rising nationwide and these costs may continue to increase during the remainder of 2019.

Net occupancy expense decreased during the three months ended March 31, 2019, compared to the same period in 2018, due to a decrease in depreciation expense from acquired Diboll assets that became fully depreciated during 2018, as well as a decrease in rent expense due to additional rent expense of \$164,000 recorded during the first quarter of 2018 in connection with the closure of one of our retail branches located within close proximity to an acquired Diboll location.

For the three months ended March 31, 2018, acquisition expense consisted primarily of \$652,000 in change in control payment accruals and severance payments and \$180,000 in additional professional fees.

Advertising, travel and entertainment expense increased during the three months ended March 31, 2019, compared to the same period in 2018, primarily due to increases in media advertising and donations.

ATM expense decreased for the three months ended March 31, 2019, compared to the same period in 2018, due to higher costs initially recognized after the Diboll acquisition in late 2017 related to Diboll ATM expense.

Professional fees increased for the three months ended March 31, 2019, compared to the same period in 2018, primarily due to increases in audit and legal fees.

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FDIC insurance decreased for the three months ended March 31, 2019, compared to the same period in 2018, due to a decrease in our FDIC assessment base and rate.

Amortization expense on intangibles decreased for the three months ended March 31, 2019, compared to the same period in 2018, primarily due to a decrease in core deposit intangible amortization which is recognized on an accelerated method resulting in a decline in expense over time.

The decrease in other noninterest expense for the three months ended March 31, 2019, compared to the same period in 2018, was primarily due to decreases in losses on other real estate owned, online banking expense, printing and supplies expense, credit card related expense, losses on loans sold with recourse and other various noninterest expenses related to cost synergies due to the full integration of Diboll in 2019, compared to the partial integration in the first quarter of 2018. These decreases were partially offset by an increase computer supplies and the net periodic benefit cost of retirement plans.

#### Income Taxes

Pre-tax income for the three months ended March 31, 2019 was \$22.0 million, compared to \$18.3 million for the same period in 2018. We recorded income tax expense of \$3.1 million for the three months ended March 31, 2019, compared to income tax expense of \$2.1 million for the same period in 2018. The effective tax rate (“ETR”) as a percentage of pre-tax income was 14.3% for the three months ended March 31, 2019, compared to an ETR as a percentage of pre-tax income of 11.4% for the same period in 2018. The higher ETR for the three months ended March 31, 2019, compared to the same period in 2018, was mainly due to a decrease in tax-exempt income as a percentage of pre-tax income.

The ETR differs from the stated rate of 21% for the three months ended March 31, 2019 and 2018 primarily due to the effect of tax-exempt income from municipal loans and securities, as well as bank owned life insurance. The net deferred tax asset totaled \$491,000 at March 31, 2019, compared to \$9.8 million at December 31, 2018. The \$9.3 million decrease in the net deferred tax asset is primarily the result of the increase in unrealized gain in the AFS securities portfolio.

See “Note 12-Income Taxes” to our consolidated financial statements included in this report. No valuation allowance for the net deferred tax asset was recorded at March 31, 2019 or December 31, 2018, as management believes it is more likely than not that all of the net deferred tax asset 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 cash, interest earning deposits and short-term investments that can be readily liquidated with a minimum risk of loss. At March 31, 2019, these investments were 6.6% of total assets, as compared with 4.0% for December 31, 2018 and 6.4% for March 31, 2018. The increase to 6.6% at March 31, 2019 is primarily reflective of an increase in our 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 \$40.0 million, \$15.0 million and \$7.5 million, respectively. There were no federal funds purchased at March 31, 2019. There were \$28.0 million federal funds purchased at December 31, 2018. Southside Bank has a \$5.0 million line of credit with Frost Bank to be used to issue letters of credit, and at March 31, 2019, we had one outstanding letter of credit for \$195,000. At March 31, 2019, the amount of additional funding Southside Bank could obtain from FHLB, collateralized by securities, FHLB stock and nonspecified loans and securities was approximately \$1.34 billion, net of FHLB stock purchases required. Southside Bank currently has no outstanding letters of credit from FHLB held as collateral for its public fund deposits.

Interest rate sensitivity management seeks to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The ALCO closely monitors various liquidity ratios and interest rate spreads and margins. The ALCO utilizes a simulation model to perform 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, among others to assist in determining our overall interest rate risk and the adequacy of our liquidity position. In addition, the ALCO utilizes this simulation model to determine the impact on net interest income of various 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.

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## Capital Resources

Our total shareholders' equity at March 31, 2019 increased 3.7%, or \$26.7 million, to \$758.0 million, or 12.2% of total assets, compared to \$731.3 million, or 11.9% of total assets at December 31, 2018.

The increase in shareholders' equity was the result of a decrease in accumulated other comprehensive loss of \$34.5 million, net income of \$18.8 million, stock compensation expense of \$661,000, common stock issued under our dividend reinvestment plan of \$355,000 and net issuance of common stock under employee stock plans of \$338,000, partially offset by a reduction to retained earnings of \$16.5 million for a cumulative-effect adjustment related to the adoption of ASU 2017-08, as well as cash dividends paid of \$10.1 million and the repurchase of \$1.3 million of our common stock.

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 "2015 Capital Rules"). The 2015 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 2015 Capital Rules also established the following minimum capital ratios: 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 2015 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 2015 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 carrybacks 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 AOCI items included in shareholders' equity under U.S. GAAP were excluded for the purposes of determining capital ratios. Under the 2015 Capital Rules, the Company has elected to permanently exclude capital in AOCI in Common Equity Tier 1 capital, Tier 1 capital, Total capital to risk-weighted assets and Tier 1 capital to adjusted quarterly average assets.

Under the 2015 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 2015 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 March 31, 2019, 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 the 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 the 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 (dollars in thousands):

|   | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Actions Provisions |        |
|---|-----------|--------|-------------------------------|-------|---|--------|
|   | Amount    | Ratio  | Amount                        | Ratio | Amount  | Amount |
| March 31, 2019                                    |           |        |                               |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets)    |           |        |                               |       |   |        |
| Consolidated                                      | \$561,566 | 14.38% | \$175,725                     | 4.50% | N/A   | N/A    |
| Bank Only   | \$696,364 | 17.83% | \$175,712                     | 4.50% | \$253,806   | 6.50%  |
| Tier 1 Capital (to Risk-Weighted Assets)          |           |        |                               |       |   |        |
| Consolidated                                      | \$620,002 | 15.88% | \$234,300                     | 6.00% | N/A   | N/A    |
| Bank Only   | \$696,364 | 17.83% | \$234,282                     | 6.00% | \$312,376   | 8.00%  |
| Total Capital (to Risk-Weighted Assets)           |           |        |                               |       |   |        |
| Consolidated                                      | \$744,439 | 19.06% | \$312,400                     | 8.00% | N/A   | N/A    |
| Bank Only   | \$722,353 | 18.50% | \$312,376                     | 8.00% | \$390,470   | 10.00% |
| Tier 1 Capital (to Average Assets) <sup>(1)</sup> |           |        |                               |       |   |        |
| Consolidated                                      | \$620,002 | 10.18% | \$243,676                     | 4.00% | N/A   | N/A    |
| Bank Only   | \$696,364 | 11.44% | \$243,549                     | 4.00% | \$304,437   | 5.00%  |
| December 31, 2018                                 |           |        |                               |       |   |        |
| Common Equity Tier 1 (to Risk-Weighted Assets)    |           |        |                               |       |   |        |
| Consolidated                                      | \$568,283 | 14.77% | \$173,174                     | 4.50% | N/A   | N/A    |
| Bank Only   | \$714,991 | 18.59% | \$173,095                     | 4.50% | \$250,026   | 6.50%  |
| Tier 1 Capital (to Risk-Weighted Assets)          |           |        |                               |       |   |        |
| Consolidated                                      | \$626,718 | 16.29% | \$230,899                     | 6.00% | N/A   | N/A    |
| Bank Only   | \$714,991 | 18.59% | \$230,793                     | 6.00% | \$307,725   | 8.00%  |
| Total Capital (to Risk-Weighted Assets)           |           |        |                               |       |   |        |
| Consolidated                                      | \$754,034 | 19.59% | \$307,865                     | 8.00% | N/A   | N/A    |
| Bank Only   | \$743,900 | 19.34% | \$307,725                     | 8.00% | \$384,656   | 10.00% |
| Tier 1 Capital (to Average Assets) <sup>(1)</sup> |           |        |                               |       |   |        |
| Consolidated                                      | \$626,718 | 10.64% | \$235,689                     | 4.00% | N/A   | N/A    |
| Bank Only   | \$714,991 | 12.14% | \$235,532                     | 4.00% | \$294,415   | 5.00%  |

(1)

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

Management believes that, as of March 31, 2019, 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.

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The table below summarizes our key equity ratios for the periods presented:

|  | Three Months<br>Ended<br>March 31, |        |
|--|------------------------------------|--------|
|  | 2019                               | 2018   |
| Return on average assets                             | 1.21 %                             | 1.02 % |
| Return on average shareholders' equity               | 10.35                              | 8.75   |
| Dividend payout ratio – Basic                        | 53.57                              | 60.87  |
| Dividend payout ratio – Diluted                      | 53.57                              | 60.87  |
| Average shareholders' equity to average total assets | 11.70                              | 11.69  |

## 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, 2018 for a discussion of our primary market area and the geographic concentration of our loan portfolio as of December 31, 2018. There were no substantial changes in these concentrations during the three months ended March 31, 2019. 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 primarily throughout the state of Texas. Municipal loans are made to municipalities, counties, school districts and colleges.

The following table sets forth loan totals by class as of the dates presented (dollars in thousands):

|                        | Compared to    |                   | December 31, 2018 |            | March 31, 2018 |  |
|------------------------|----------------|-------------------|-------------------|------------|----------------|--|
|                        | March 31, 2019 | December 31, 2018 | March 31, 2018    | Change (%) | Change (%)     |  |
| Real estate loans:     |                |                   |                   |            |                |  |
| Construction           | \$603,411      | \$507,732         | \$474,791         | 18.8 %     | 27.1 %         |  |
| 1-4 family residential | 786,198        | 794,499           | 797,088           | (1.0) %    | (1.4) %        |  |
| Commercial             | 1,104,378      | 1,194,118         | 1,285,591         | (7.5) %    | (14.1) %       |  |
| Commercial loans       | 367,995        | 356,649           | 281,901           | 3.2 %      | 30.5 %         |  |
| Municipal loans        | 343,026        | 353,370           | 342,404           | (2.9) %    | 0.2 %          |  |
| Loans to individuals   | 100,102        | 106,431           | 127,852           | (5.9) %    | (21.7) %       |  |
| Total loans            | \$3,305,110    | \$3,312,799       | \$3,309,627       | (0.2) %    | (0.1) %        |  |

Our loan portfolio decreased \$7.7 million, or 0.2%, at March 31, 2019 compared to December 31, 2018 in the commercial real estate, municipal loans, 1-4 family residential and loans to individuals portfolios, with those decreases partially offset by increases in the construction loan and commercial loan portfolios.

Our loan portfolio decreased \$4.5 million, or 0.1%, at March 31, 2019 compared to March 31, 2018 in loans to individuals, commercial real estate, and 1-4 family residential loan portfolios, with those decreases partially offset by increases in the commercial loan and construction loan portfolios.

At March 31, 2019, our real estate loans represented 75.5% of our loan portfolio and are comprised of construction loans of 24.2%, 1-4 family residential loans of 31.5% and commercial real estate loans of 44.3%. 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 1-4 family residential loans consist primarily of loans secured by first mortgages on owner occupied 1-4 family residences. 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.

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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 30 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. Despite a significant reduction in oil prices during 2015 and 2016 when the price per barrel of crude oil traded below \$30 at one point, the Texas economy as a whole has continued to perform very well, reflective of the economic diversity Texas has achieved. Energy loans comprised approximately 3.06% and 1.92% of our loan portfolio at March 31, 2019 and December 31, 2018, respectively. During the last three years, economic growth, employment gains and business activity across a wide range of industries and regions in the U.S. has experienced slow but steady growth. During a majority of that time economic growth and business activity in certain Texas markets we serve exceeded that of the U.S. average. We cannot predict whether current economic conditions will improve, remain the same or decline.

#### 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 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 the review we determine it is probable 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 allowance. 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 loans.

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 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 March 31, 2019, our review of the loan portfolio indicated that a loan loss allowance of \$24.2 million was appropriate to cover probable losses in the portfolio. Changes in economic and other conditions, including the adoption of ASU 2016-13, "Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses of Financial Instruments" ("CECL"), which is effective beginning with the first quarter of 2020, may require future adjustments to the allowance for loan losses.

During the three months ended March 31, 2019, the allowance for loan losses decreased \$2.9 million, or 10.6%, to \$24.2 million, or 0.73% of total loans, when compared to \$27.0 million, or 0.82% of total loans at December 31, 2018. The decrease in the

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allowance for loan losses was primarily the result of \$1.2 million in charge-offs associated with the three nonaccrual loans sold during the first quarter of 2019 that were previously in nonaccrual status and a partial reversal of provision in the first quarter.

For the three months ended March 31, 2019, loan charge-offs were \$2.3 million and recoveries were \$339,000. For the three months ended March 31, 2018, loan charge-offs were \$767,000 and recoveries were \$471,000. For the three months ended March 31, 2019, we recorded a partial reversal of provision of \$918,000, a decrease of \$4.7 million, or 124.6%, from \$3.7 million, for the comparable period in 2018. The decrease in provision expense for the three months ended March 31, 2019 was primarily due to three large commercial real estate loans placed on nonaccrual status in 2018 that were sold during the first quarter of 2019.

**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 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 agreements. 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, 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 are considered in judgments as to potential loan loss.

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

|  | March 31,<br>2019 | December 31,<br>2018 | March 31,<br>2018 | Change<br>(%) | Compared to<br>December<br>31, 2018 | March 31,<br>2018 | Change (%) |
|--|-------------------|----------------------|-------------------|---------------|-------------------------------------|-------------------|------------|
| Loans on nonaccrual:                                     |                   |                      |                   |               |                                     |                   |            |
| Real estate loans:                                       |                   |                      |                   |               |                                     |                   |            |
| Construction   | \$ 8              | \$ 12                | \$ 71             | (33.3)%       | (88.7)                              | )%                |            |
| 1-4 family residential                                   | 1,395             | 2,202                | 1,739             | (36.6)%       | (19.8)                              | )%                |            |
| Commercial real estate                                   | 15,266            | 32,599               | 31,196            | (53.2)%       | (51.1)                              | )%                |            |
| Commercial   | 758               | 639                  | 1,142             | 18.6%         | (33.6)                              | )%                |            |
| Loans to individuals                                     | 264               | 318                  | 397               | (17.0)%       | (33.5)                              | )%                |            |
| Total nonaccrual loans <sup>(1)</sup>                    | 17,691            | 35,770               | 34,545            | (50.5)%       | (48.8)                              | )%                |            |
| Accruing loans past due more than 90 days <sup>(1)</sup> | 7,927             | —                    | 4                 | 100.0%        | 198,075.0%                          |                   |            |
| Restructured loans <sup>(2)</sup>                        | 11,490            | 5,930                | 5,839             | 93.8%         | 96.8%                               |                   |            |
| Other real estate owned                                  | 978               | 1,206                | 2,014             | (18.9)%       | (51.4)                              | )%                |            |
| Reposessed assets  | 25                | —                    | 42                | 100.0%        | (40.5)                              | )%                |            |
| Total nonperforming assets                               | \$ 38,111         | \$ 42,906            | \$ 42,444         | (11.2)%       | (10.2)                              | )%                |            |
| Asset quality ratios:                                    |                   |                      |                   |               |                                     |                   |            |
| Nonaccruing loans to total loans                         | 0.54%             | 1.08%                | 1.04%             |               |                                     |                   |            |
| Allowance for loan losses to nonaccruing loans           | 136.54            | 75.54                | 70.11             |               |                                     |                   |            |
| Allowance for loan losses to nonperforming assets        | 63.38             | 62.97                | 57.06             |               |                                     |                   |            |
| Allowance for loan losses to total loans                 | 0.73              | 0.82                 | 0.73              |               |                                     |                   |            |
| Nonperforming assets to total assets                     | 0.61              | 0.70                 | 0.67              |               |                                     |                   |            |
| Net charge-offs to average loans                         | 0.24              | 0.07                 | 0.04              |               |                                     |                   |            |

(1) Excludes PCI loans measured at fair value at acquisition if the timing and amount of cash flows expected to be collected from those sales can be reasonably estimated.

(2) Includes \$719,000, \$3.1 million and \$2.9 million in PCI loans restructured as of March 31, 2019, December 31, 2018 and March 31, 2018, respectively.

Our accruing loans past due more than 90 days consisted of one commercial real estate loan that paid off in full on April 15, 2019. Additionally, our restructured loans increased \$5.6 million due to the renegotiation of a commercial real estate loan.

The OREO at March 31, 2019 consisted of construction, 1-4 family residential and commercial real estate properties. We are actively marketing all OREO properties and none are being held for investment purposes.

#### Acquisition

See “Note 2 - 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, 2018. There have been no significant changes in the types of market risks we face since December 31, 2018.

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. Due to the low level of interest rates, many of the current interest rates cannot decline 100 or 200 basis points. The model has floors for each of those interest rates, and none are assumed to go negative. As of March 31, 2019, 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 2.74% and 1.28%, 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 1.60% and 5.76%, respectively, relative to the base case over the next 12 months. As of December 31, 2018, 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 1.51% and an immediate increase in interest rates of 200 basis points would result in a negative variance on net interest income of 1.29%, relative to the base case over the next 12 months, while immediate decreases in interest rates of 100 and 200 basis points would result in negative variances on net interest income of 0.22% and 3.34%, respectively, relative to the base case over the next 12 months. As of March 31, 2018, 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 1.63% and 0.41%, 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 0.94% and 4.78%, 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 March 31, 2019 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, 2018. 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, 2018. The risks and uncertainties described in our Annual Report on Form 10-K for the year ended December 31, 2018 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.





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## ITEM 6. EXHIBITS

## Exhibit Index

| Exhibit Number   | Exhibit Description  | Filed Herewith | Incorporated by Reference |      |             |          |
|------------------|--|----------------|---------------------------|------|-------------|----------|
|                  |  |                | Exhibit                   | Form | Filing Date | File No. |
| (3)<br>3.1       | Articles of Incorporation and Bylaws<br><u>Restated Certificate of Formation of Southside Bancshares, Inc.</u> |                | 3.1                       | 8-K  | 05/14/2018  | 0-12247  |
| 3.2              | <u>Amended and Restated Bylaws of Southside Bancshares, Inc.</u>   |                | 3.1                       | 8-K  | 02/22/2018  | 0-12247  |
| (31)<br>31.1     | Rule 13a-14(a)/15d-14(a) Certifications<br><u>Certification of Chief Executive Officer</u>                     | X              |                           |      |             |          |
| 31.2             | <u>Certification of Chief Financial Officer</u>  | X              |                           |      |             |          |
| (32)<br>†32      | Section 1350 Certification<br><u>Certification of Executive Officer and Chief Financial Officer</u>            | X              |                           |      |             |          |
| (101)<br>101.INS | Interactive Data File<br>XBRL Instance Document.   | X              |                           |      |             |          |
| 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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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: April 30, 2019 BY: /s/ Lee R. Gibson  
Lee R. Gibson, CPA  
President and Chief Executive Officer  
(Principal Executive Officer)

DATE: April 30, 2019 BY: /s/ Julie N. Shamburger  
Julie N. Shamburger, CPA  
Senior Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)